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Republic of Latvia: Staff Report for the 1999 Article IV Consultation

This report was prepared by a staff team of the International Monetary Fund following discussions with the officials of Republic of Latvia on economic developments and policies. The report was then considered by the IMF's Executive Board in the context of the IMF's periodic consultation with Republic of Latvia, as required under Article IV of the IMF Articles of Agreement. The views expressed in the staff report itself are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF or of the authorities of Republic of Latvia; a supplementary statement by IMF staff may also be included. The views of the Executive Board as expressed in the discussion of the Article IV consultation report and as summarized in a Public Information Notice (PIN) are also included. In addition, a statement by the member country authorities may be appended. Further background documentation prepared by IMF staff for the consultation may be published separately at a later date.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF LATVIA

Staff Report for the 1999 Article IV Consultation

Prepared by the Staff Representatives for the
1999 Consultation with the Republic of Latvia

Approved by Oleh Havrylyshyn and Russell G. Kincaid

July 9, 1999

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Latvia: Basic Data

Social and demographic indicators 1/				
Area	64,589 sq. km.			
Population	2.4 million			
Urban	69 percent			
Rate of population growth	-0.8 percent per year			
Life expectancy at birth				
Male	64 years			
Female	75 years			
Infant mortality rate (per 1,000 births)	14.9			
Hospital beds (per 10,000 inhabitants)	95			
Physicians (per 10,000 inhabitants)	33			

	1995	1996	1997	1998
	In percent of GDP			
Shares of gross domestic product				
Agriculture and fishing	10.8	9.0	8.1	7.5
Industry	22.6	21.2	21.2	21.2
Electricity	5.5	5.3	4.1	4
Construction	5.1	4.7	4.5	4.8
Services	56.0	59.9	62.1	62.5
GDP				
Nominal GDP (in million of lats)	2,349	2,829	3,275	3,774
GDP per capita (in lats)	934	1,136	1,326	1,541
Real GDP (percentage change)	-0.8	3.3	8.6	3.6
Consumer prices (percentage change, end-period)	23	13	7	3
General government finances				
Total revenue	875	1,076	1,288	1,530
(in percent of GDP)	37.2	38.0	39.3	40.6
Total expenditure	952	1,118	1,275	1,557
(in percent of GDP)	40.5	39.5	38.9	41.3
Financial balance	-77	-43	13	-26
(in percent of GDP)	-3.3	-1.5	0.4	-0.7
Net lending	15	5	10	2.6
(in percent of GDP)	0.6	0.2	0.3	0.1
Fiscal balance	-92	-48	3	-29
(in percent of GDP)	-3.9	-1.7	0.1	-0.8
Money and credit (end-period)				
Net foreign assets	300	445	619	415
Broad money	524	628	871	923
Domestic credit	332	366	479	647
Velocity (level)	4.5	4.5	3.8	4.1
Balance of payments				
Total exports (GNFS)	1,102	1,475	1,702	1,863
Total imports (GNFS)	1,156	1,668	1,945	2,303
Current account balance	-9	-121	-170	-346
Official reserves (in months of imports of goods and nonfactor services)	3.2	3.1	3.0	2.7
Exchange rate, lats per US$, end-period	0.537	0.556	0.590	0.569

Sources: Latvian authorities; and Fund staff estimates.

Executive Summary

Macroeconomic developments have been severely affected by the Russian economic crisis. Real GDP declined by 1.9 percent in the fourth quarter of 1998 and further contraction is estimated for the first quarter of 1999. Meanwhile, annual inflation has decelerated to 1.9 percent in May. The current account deficit surged to 9.5 percent of GDP in 1998 but has since narrowed substantially. While the general government ended 1998 with a slight surplus, the 1999 Budget Law foresees a fiscal deficit of 2.8 percent of GDP. Monetary developments, which reflected continued confidence in economic policies and in the banking system in the first half of 1998, have since been dominated by the August events in Russia, with most monetary aggregates declining in the immediate months following the outbreak of the crisis. Several Latvian banks were significantly impacted by Russia's default on its sovereign obligations and so far, three small banks have been closed while the operations of the fifth largest bank have been suspended.

Good general progress has continued on structural and tariff reforms, although large-scale enterprise privatization has stalled and a commitment under the previous program to lower agricultural tariffs has not yet been met. Meanwhile, measures to strengthen property rights and improve the business climate have continued.

While the macroeconomic outlook has become less certain, the medium-term outlook remains largely favorable provided that Latvia maintains prudent financial policies and moves expeditiously toward completing its agenda of structural reforms. GDP is expected to grow by a modest 2 percent and 4 percent, respectively, in 1999-2000, then rise by 6 percent in the medium term reflecting increased public savings, investment, and productivity. Inflation is expected to stay below 3 percent as it converges to the level of industrialized countries while the current account deficit is projected to narrow to 8.4 percent of GDP in 1999 and to about 5 percent over the medium term. The SDR exchange rate peg, which has served Latvia well, will remain a key feature of economic policy.

Completion of the program of structural reform will solidify prospects for sustained growth. Privatization plans for the two large remaining enterprises have recently been approved, envisaging sales in 1999 and 2000. Pension, public sector administration, and tax reform are progressing; financial sector supervision is being further reinforced; apartment privatization and land registration are moving ahead, although both somewhat slower than originally envisaged; and further steps are being taken to strengthen property rights and improve the overall business climate. Latvia's accession to the EU remains an important objective and its economic program is closely tied to meeting accession requirements.

In the short-run, the most obvious risks pertain to the impact on the Latvian economy and financial system of the crisis in Russia, both through its effects on the external balance and on the solidity of the banking system.

I. Introduction

1. The Executive Board approved an 18-month stand-by arrangement in the amount of SDR 33 million (then equivalent to 24 percent of quota on an annual basis) on October 10, 1997.[1] The authorities indicated their intention to treat the arrangement as precautionary and the arrangement has expired without any purchases. On October 27, 1998 Latvia consented to its increase in quota under the Eleventh General Review. Repurchases have reduced Latvia's outstanding use of Fund credit to SDR 39.3 million, or 31.0 percent of quota (Appendix I).

2. Discussions for the 1999 Article IV Consultation and negotiations for a successor stand-by arrangement (SBA) took place in Riga during May 11-20, 1999.[2] The mission met with the Prime Minister, the Minister of Finance, the Governor of the Bank of Latvia (BoL), other senior officials, and representatives of the private sector. Negotiations for a successor SBA will continue in September at the request of the authorities, who felt that they then would be in a better position to commit to a much tighter budget for 2000, perhaps additional measures for 1999 in a supplementary budget, and the necessary steps in large-scale privatization. All end-December performance criteria under the previous stand-by arrangement but one were observed (Table 1): while the limit on net domestic assets of the BoL was exceeded due to a technical error; this was immediately corrected.

3. The Executive Board concluded the 1998 Article IV consultation and the first review under the previous stand-by arrangement on March 23, 1998 and the second review on November 6, 1998. On both those occasions, Directors commended the authorities for their prudent financial policies and for making substantial headway on the comprehensive structural reforms required for establishing a market economy. However, they expressed concern about the slowdown in some elements of the structural reform agenda, especially the privatization of large enterprises, and urged the authorities to accelerate this process in order to sustain economic growth and move toward their goal of European Union (EU) accession. Furthermore, Directors emphasized the need to resolve any remaining problems in the banking sector.

4. Loans approved by the World Bank since 1992 amount to US$305 million in total commitments and debt outstanding, including closed operations (Appendix II). Extensive

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[1]Board paper EBS/97/174 (9/12/97).

[2]The staff representatives were Mr. Havrylyshyn (head), Ms. Westin, Mr. Zytek, Ms. Richter (all EU2), Mr. Sakr (PDR), and Mr. Mesquita (MAE). Mr. Demekas, the Fund's resident representative in Latvia, assisted the mission. Mr. Odling-Smee, Director of EU2, joined the mission for a couple of days. Also, Mr. Hansen, Executive Director for Latvia, and Mr. Carlens, Assistant to the Executive Director, attended some of the meetings.

technical assistance has been provided by the Fund (Appendix III), as well as by other multilateral organizations, notably the World Bank and the EU/PHARE, and bilateral sources.

5. The Latvian authorities provide the Fund with core data for surveillance. The periodicity and availability of the most important statistics are adequate and are presented in Appendix IV. However, improvements are still needed, in particular in balance of payments and national accounts data, and starting September, a one-year resident advisor in balance of payments statistics is to be shared between Latvia and Lithuania. In addition, Latvia has subscribed to the Fund's Special Data Dissemination Standard since November 1996, and has posted metadata on the Dissemination Standard Bulletin Board since December 1997.

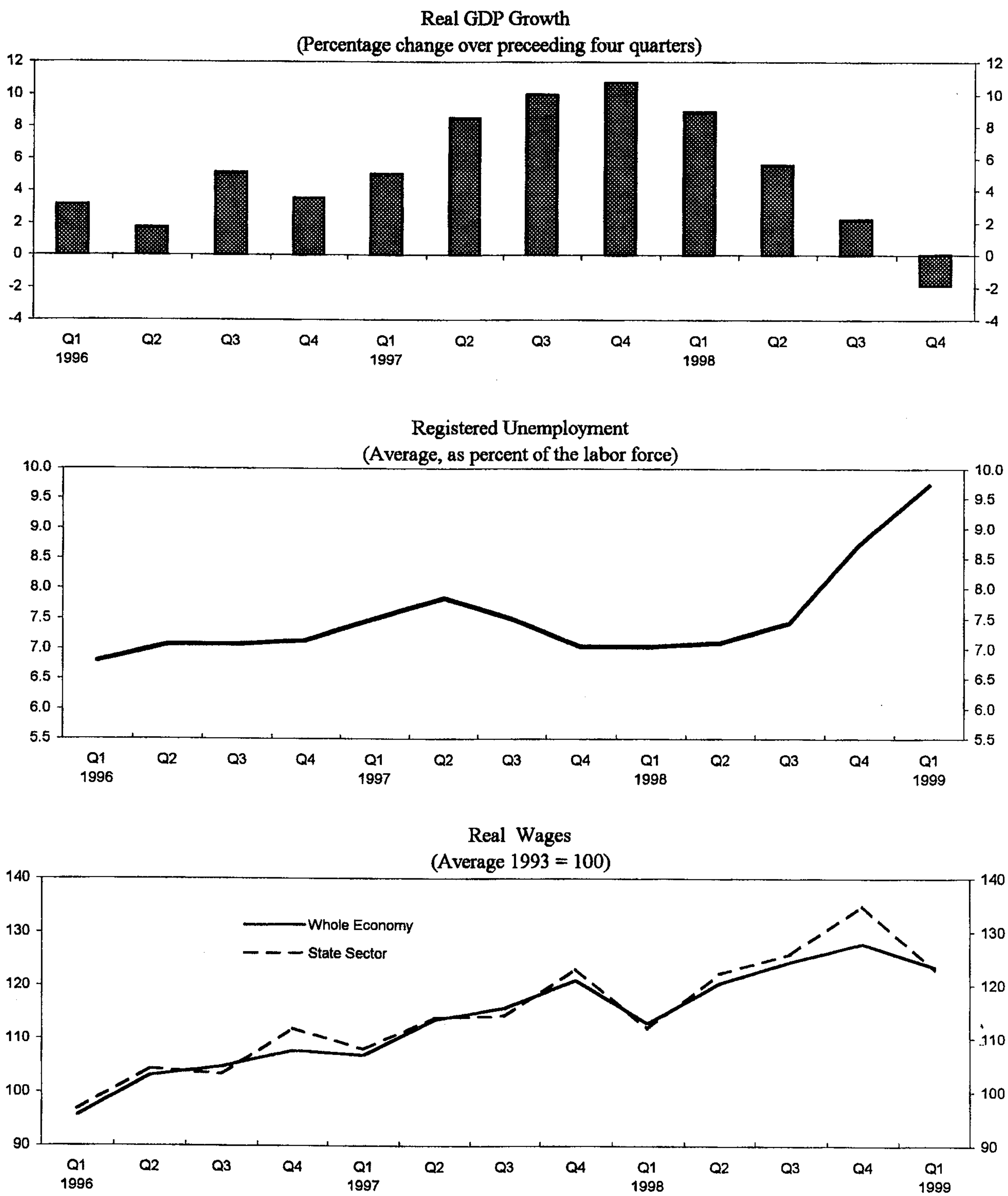
II. Recent Economic Developments and Performance Under the Previous Stand-By Arrangement

6. Latvia has a solid record of macroeconomic stability and substantial progress on structural reforms. At present, the authorities are facing the policy challenge of limiting the impact of the Russian crisis while ensuring a sustainable external position. Also, while further efforts are still needed, significant steps forward have been made toward concluding the agenda of structural reforms, which will ensure future sustainable growth.

7. Real GDP growth slowed in 1998 due to the adverse direct and region-wide effects of the economic downturn in Russia. After having increased by 8.6 percent in 1997 and by 7.2 percent during the first half of 1998 compared with the same period the previous year, real GDP growth slowed considerably in the second half of the year, contracting by 1.9 percent in the fourth quarter (Table 2 and Figure 1). Preliminary data point to a further contraction in GDP in the first quarter of 1999. The sectors most affected by the downturn are manufacturing, agriculture, and fishing, while construction and services maintained fairly strong growth during the second half of 1998. The official rate of unemployment reached 10.1 percent in May, up more than 3 percentage points from a year earlier. Continued tight monetary policy and weakening domestic demand have contributed to the rapid fall in inflation, which reached 1.9 percent in May on a twelve-month basis (Figure 2). Underlying inflation is even lower: excluding increases in administered prices, consumer prices rose by 1.1 percent during the first four months of the year compared with a 1.2 percent increase in the overall index. Furthermore, producer prices have been declining year-on-year since December 1998, with the annual rate of deflation reaching 4.4 percent in April.

8. The external current account deficit widened from 5.1 percent of GDP in 1997 to 9.5 percent of GDP in 1998 reflecting a sharp decline in exports to CIS countries and a reduction in Russian transit trade in the second half of 1998 (Table 3 and Figure 3). However, with still robust export growth to non-CIS countries, total exports grew by about 11 percent. Import growth in 1998 remained buoyant, at about 15 percent, but started to decline toward the end of the year, mirroring, with a lag, the slowdown in economic activity. Capital inflows remained strong despite the Russian crisis. While foreign direct investment declined reflecting delays in the privatization program, medium and long-term borrowing by banks and enterprises increased. Market sentiment remained favorable, with only minimal foreign exchange market intervention

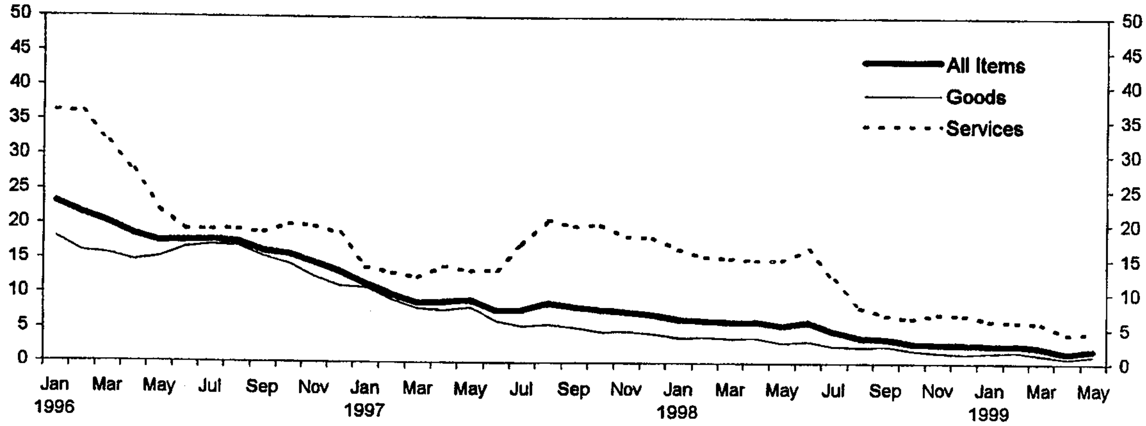
Figure 1. Latvia: Macroeconomic Indicators, 1996-99



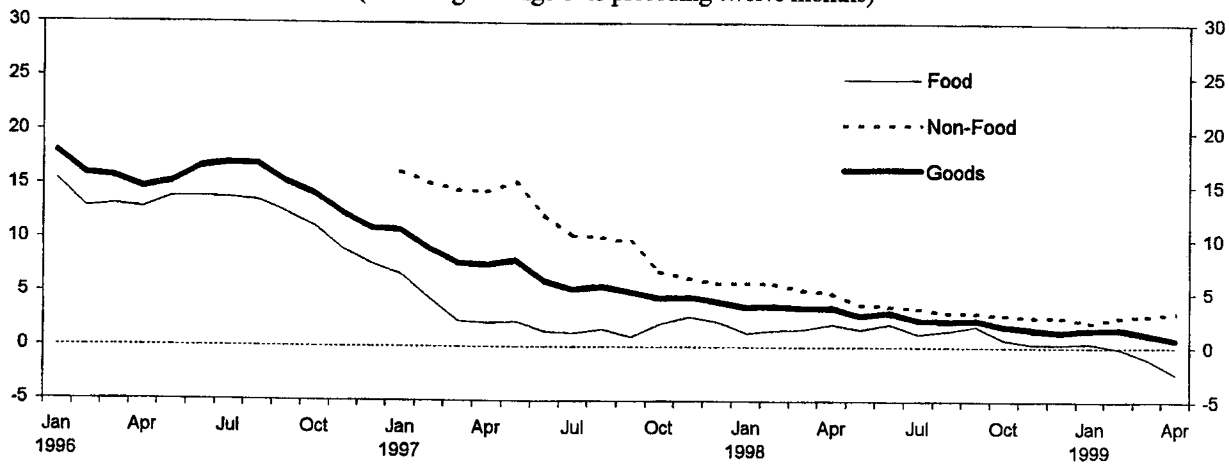
Sources: Latvian authorities and Fund staff estimates.

Figure 2. Latvia : Price and Wage Developments, 1996-99

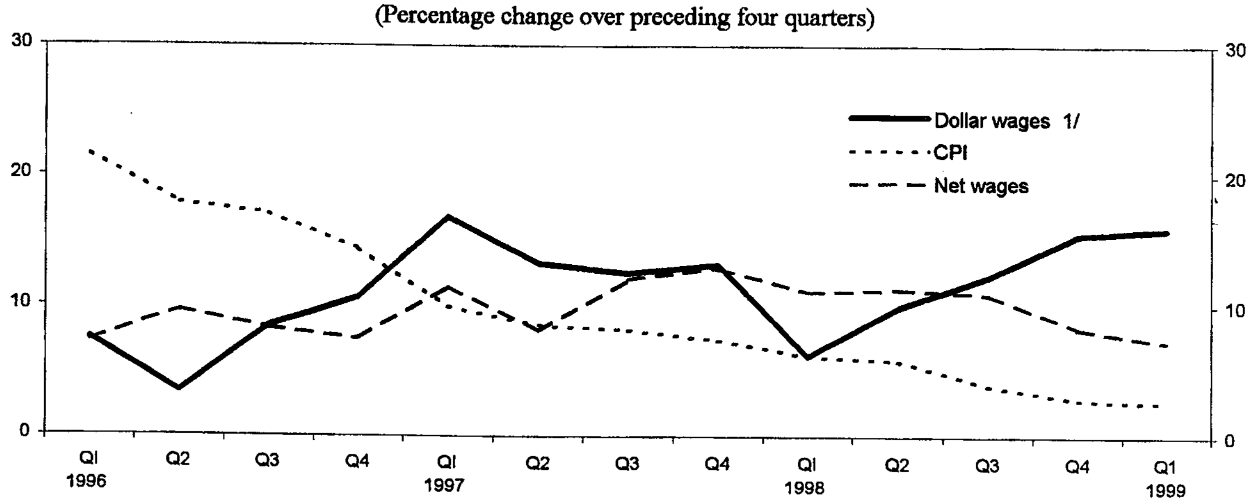
CPI Inflation in Goods and Services
(Percentage change over preceding twelve months)



CPI Inflation in Goods Sector
(Percentage change over preceding twelve months)

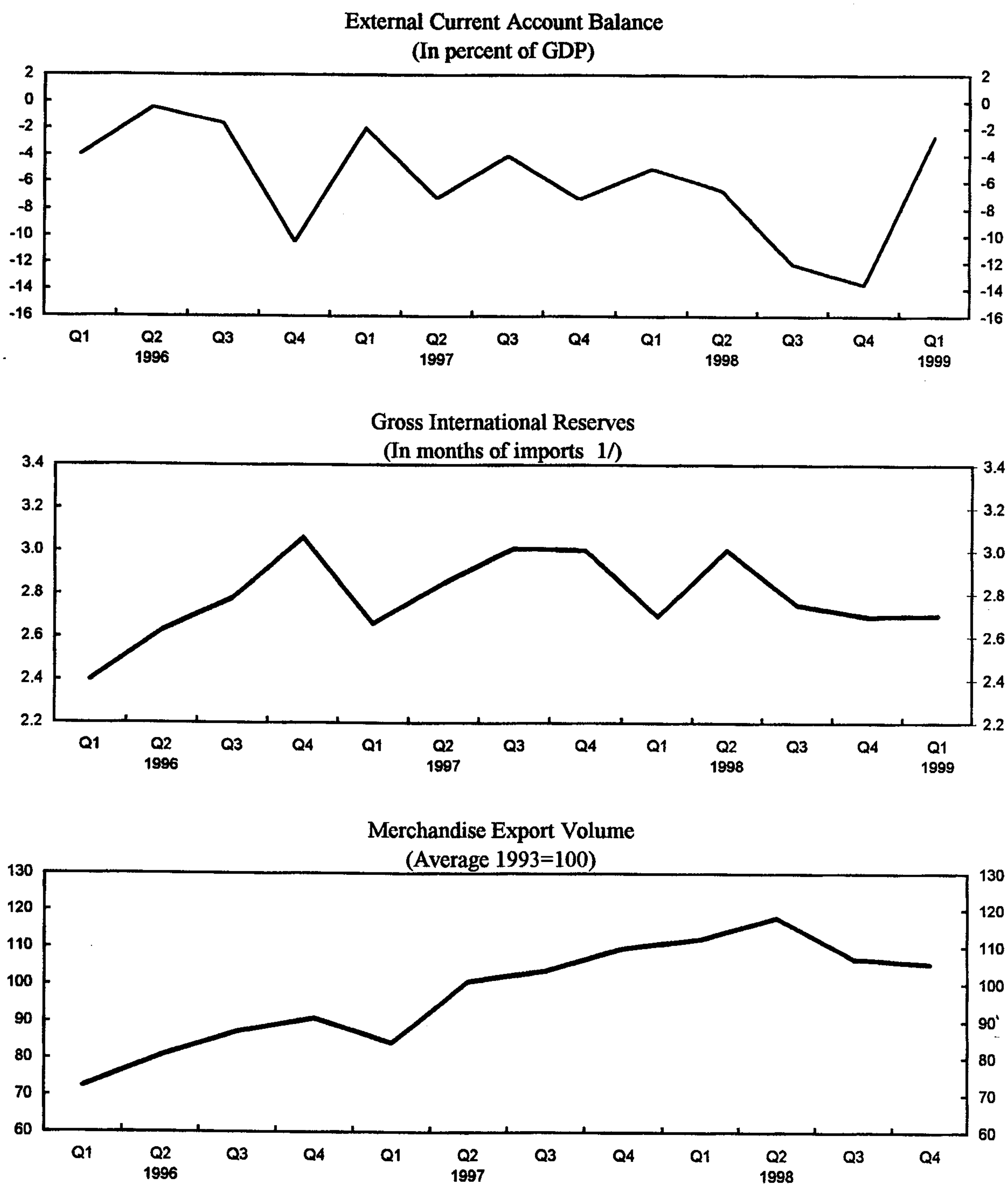


Dollar Wages, Net Wages and Consumer Price Index
(Percentage change over preceding four quarters)



Sources: Latvian authorities and Fund staff estimates.
1/ Average monthly wage in the public sector, including public enterprises.

Figure 3. Latvia: External Indicators, 1996-99



Sources: Data provided by the Latvian authorities, and Fund staff estimates..
1/ Imports of goods and non-factor services.

occurring in the aftermath of the Russian crisis. By end-1998, gross official reserves had increased to US$876 million although import coverage declined moderately to 2.7 months. Latvia's external debt stood at US$1,080 million at end-1998, or 17 percent of GDP. Of this amount, US$472, or 7.4 percent of GDP, were public and publicly guaranteed loans.

9. During the first quarter of 1999, the current account deficit shrank to 2.6 percent of GDP as imports declined by 12 percent compared with the first quarter of 1998, reflecting the continued adjustment to the decline in economic activity. Exports to non-CIS countries continued to grow by some 12 percent while exports to CIS countries declined by about 70 percent compared with the same period in 1998. As a result, total exports declined by 10 percent. International rating agencies have reaffirmed their favorable rating of Latvia's credit and, in mid-May, the authorities successfully issued a five-year €150 million Eurobond at 330 basis points above the German benchmark bond. The bond was oversubscribed at issue and its spread has subsequently declined to 219 basis points on June 17. By end-June, gross international reserves stood at US$1037 million or 3.1 months of imports, indicating the receipts of the Eurobond issue. Finally, the transfer of the responsibility of the balance of payments data from the Central Statistics Office to the BoL is progressing on schedule and both organizations will produce these data in parallel for 1999 to ensure a smooth transition.

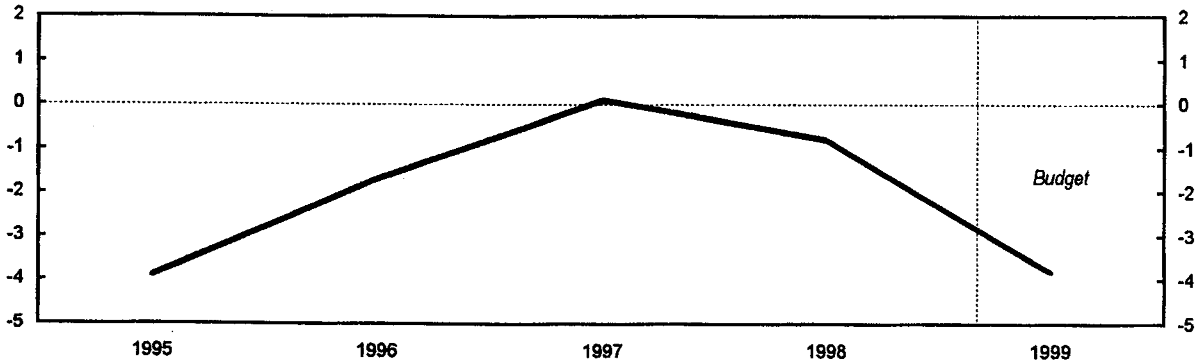
10. The 1998 fiscal outcome was slightly better than programmed, with the consolidated general government ending the year with a surplus of 0.2 percent of GDP (0.8 percent deficit when privatization receipts are treated as financing--PAF) compared with a program deficit of 0.5 percent of GDP (1.5 percent PAF) (Table 4 and Figure 4).[3] The 1999 fiscal budget aims for a consolidated fiscal deficit of LVL112 million or 2.8 percent of GDP (3.8 percent PAF).[4] The approved budget projects a 9 percent growth in tax revenues compared with the 1998 outcome. VAT receipts and excises are expected to increase by 9 and 14 percent, respectively, and personal income and social tax revenues are to increase by about 10 percent. The budget foresees a 20 percent increase in subsidies and transfers (in particular for unemployment benefits, pensions,

[3] The fiscal presentation in this report differs from previous reports in that privatization receipts are not treated as general government revenues but as financing. This classification is consistent with a revised FAD manual and will be applied in any future Fund program. The staff also advised the authorities to reclassify privatization receipts in their budgetary work. To ensure comparability with previous reporting, two values for the fiscal deficit will be shown in this report: one treating privatization receipts as revenues (PAR) in line with the current practice of the Latvian Budget Law, and another (within parentheses) treating privatization receipts as financing (PAF).

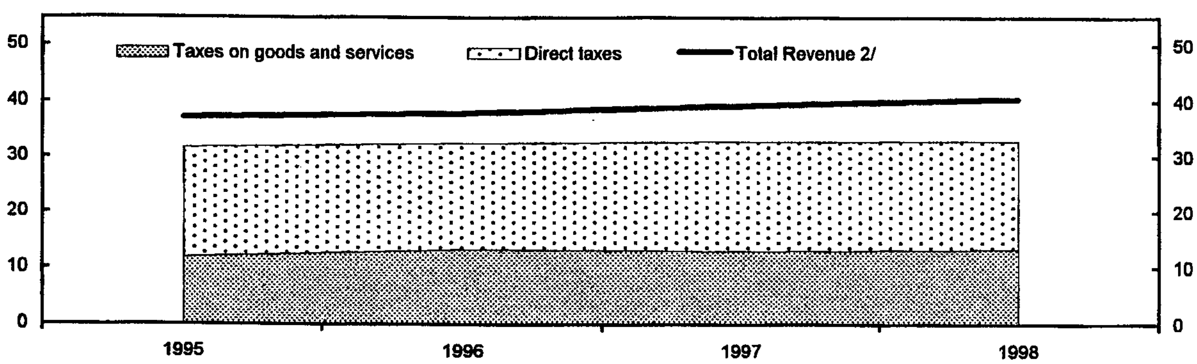
[4] Except for the impact of revenue losses and unemployment compensation, measuring a structural deficit for the Latvian economy is far from straightforward.

Figure 4. Latvia: Fiscal Developments, 1995-99
(As percentage of GDP)

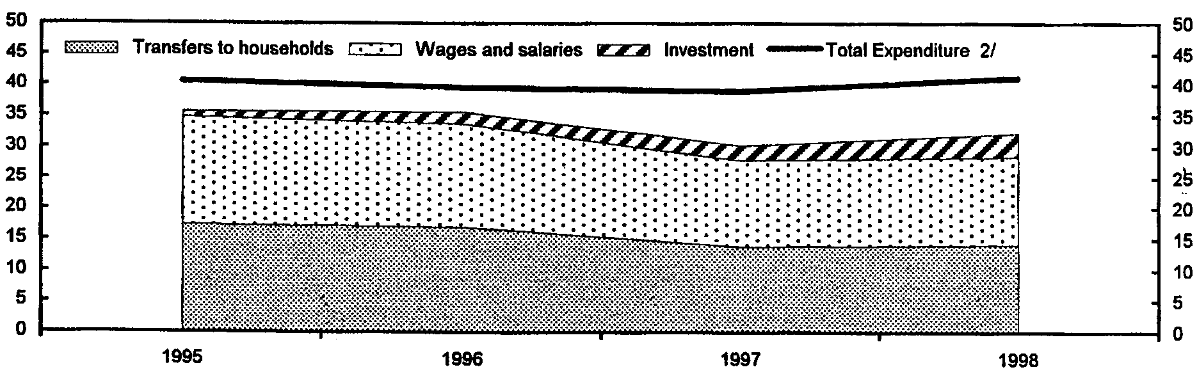
General Government Fiscal Balance 1/



General Government Revenue 1/



General Government Expenditure



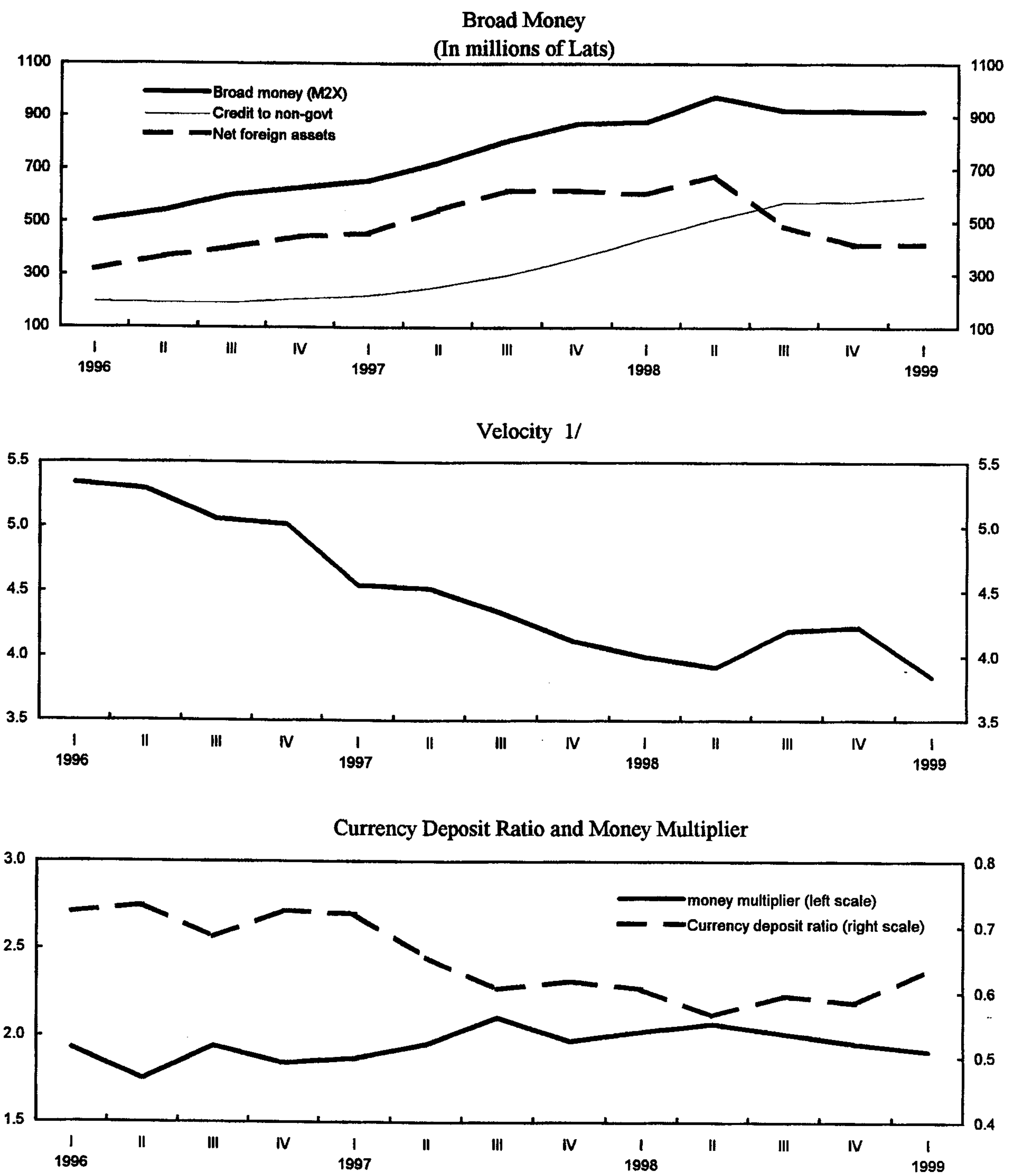
Sources: Latvian Ministry of Finance, and Fund staff estimates.
1/ Revenues exclude privatization receipts.
2/ Including interest payments and other current expenditures.

and subsidies to agriculture) and an increase in defense spending from 0.6 percent to 0.9 percent of GDP. The 1999 budget, which was drafted in mid-1998, was based on a projected 4 percent real growth rate in 1999. Furthermore, the 1999 budgetary appropriations were in part influenced by the upcoming parliamentary elections in October 1998. In particular, pension expenditures were to increase from 9.2 percent of GDP in 1998 to close to 10 percent of GDP in 1999. In the event, with no clear winner emerging from the elections, it became politically difficult to agree on spending cuts in the final Budget Law in response to the economic slowdown.

11. As a result of the economic slowdown, overall tax revenues only increased by 1.5 percent in nominal terms during the first four months of 1999 compared with the same period in 1998, primarily reflecting a 16 percent increase in personal income tax revenues, a 10 percent increase in corporate income tax receipts, and a 5 percent increase in social insurance contributions. Corporate tax receipts are not expected to increase further in 1999 as current tax receipts in part are being applied to projected future tax liabilities. Growth in income and payroll taxes reflected a 19 percent increase in the minimum wage in January and an 8 percent growth in average wages. Meanwhile, VAT receipts and excise taxes declined by 8 and 6 percent, respectively. A LVL8 million (5 percent) increase in tax arrears since December 1998 has further weakened tax revenues. With several expenditure items restrained at their 1998 levels ahead of the February budget approval, the fiscal deficit was contained at LVL7.8 million (0.9 percent of quarterly GDP) in the first quarter of 1999. This was achieved despite a 33 percent increase in pension and other social expenditures during this period. However, with the 1999 budget coming into effect, expenditures increased sharply, raising the four-month deficit to an estimated LVL21.3 million.

12. While monetary developments in the first half of 1998 indicated a continued increase in confidence in the banking system and further widening and deepening of the financial sector, developments in the second half of the year were to a large extent dominated by the August events in Russia. Reserve money, broad money and net foreign assets of the BoL and commercial banks declined in the months immediately following the outbreak of the crisis (Tables 5 and 6 and Figure 5). The situation stabilized toward the end of 1998 and over the year, reserve and broad monies grew by 7 percent and 6 percent, respectively. However, a temporary bout of uncertainty was experienced in March 1999 when the largest commercial banks experienced significant withdrawals of deposits amid reactions to the suspension of operations of Rigas KomercBanka (RKB), Latvia's fifth largest bank, and in anticipation of the publication of banks' audited 1998 financial statements at end-March. Most monetary aggregates remain below their pre-crisis levels.

Figure 5. Latvia: Monetary Developments, 1996-99



Sources: Latvian authorities, and Fund staff estimates.

1/ Velocity is defined as nominal GDP over broad money. Q1 1999 GDP is an estimate.

Longer-term lending rates for credits in lats rose by some 3-4 percentage points in the wake of the Russian crisis but have since stabilized and even started to decline (Figure 6). Interbank rates have also begun to ease even though market turnover still remains well below pre-crisis levels. Reflecting the sharp decline in inflation, all interest rates are now positive in real terms.[6]

13. Credit to the nongovernment sector rose by 51 percent in 1998, and by 3.3 percent in the first quarter of 1999, reflecting weaker demand and an increased awareness of risk on the part of banks. There are currently no signs of a deterioration in bank loan portfolios as a result of the very high credit growth in the first half of 1998. The new credit appears to be of good quality, reflecting improved loan evaluations and business accounting and auditing standards, and loans have been collateralized to an increasing extent. Non-performing loans have fallen from LVL50 million or 10 percent of total loans at end-1997 to LVL42 million or 6 percent at end-March 1999 (see Table 7 and Figure 7 for summary of financial sector indicators). However, the interpretation of these data is subject to some caution. First, they exclude banks with suspended operations; second, the quality of the collateral may be somewhat questionable;[7] and third, new regulations on loan classification standards are yet to be introduced.

14. Due to the Russian crisis and the deterioration in banks' domestic operating environment, most prudential indicators, including earnings and liquidity, worsened in 1998. The average risk-weighted capital adequacy ratio declined from 21 percent at end-1997 to about 17 percent at end-1998; according to banks' reports, it had risen to 18 percent at end-March this year.[8] Banking sector consolidation has continued, and as a result of bank closures, suspension of operations, and mergers, the number of operating banks has recently declined to 24 compared with 27 at end-1998 and 32 at end-1997. Further consolidation is expected this year ahead of the increase in the minimum required capital in January 2000. Despite its current difficulties, the banking sector has been successful in attracting significant FDI flows, particularly from Scandinavia.

15. In response to the financial spillover from Russia, the BoL tightened prudential regulations by raising the risk weight (for purposes of calculation of capital adequacy ratios) of domestic currency denominated non-OECD government debt from zero to 50 percent and by limiting banks' exposure to any one non-OECD country to 25 percent of own funds and to non-OECD countries as a whole to no more than 200 percent of own funds. Apart from intensifying its supervision of banks, the BoL also provided collateralized liquidity support to the banking system, amounting to some LVL60 million of which the major part has since been retracted.

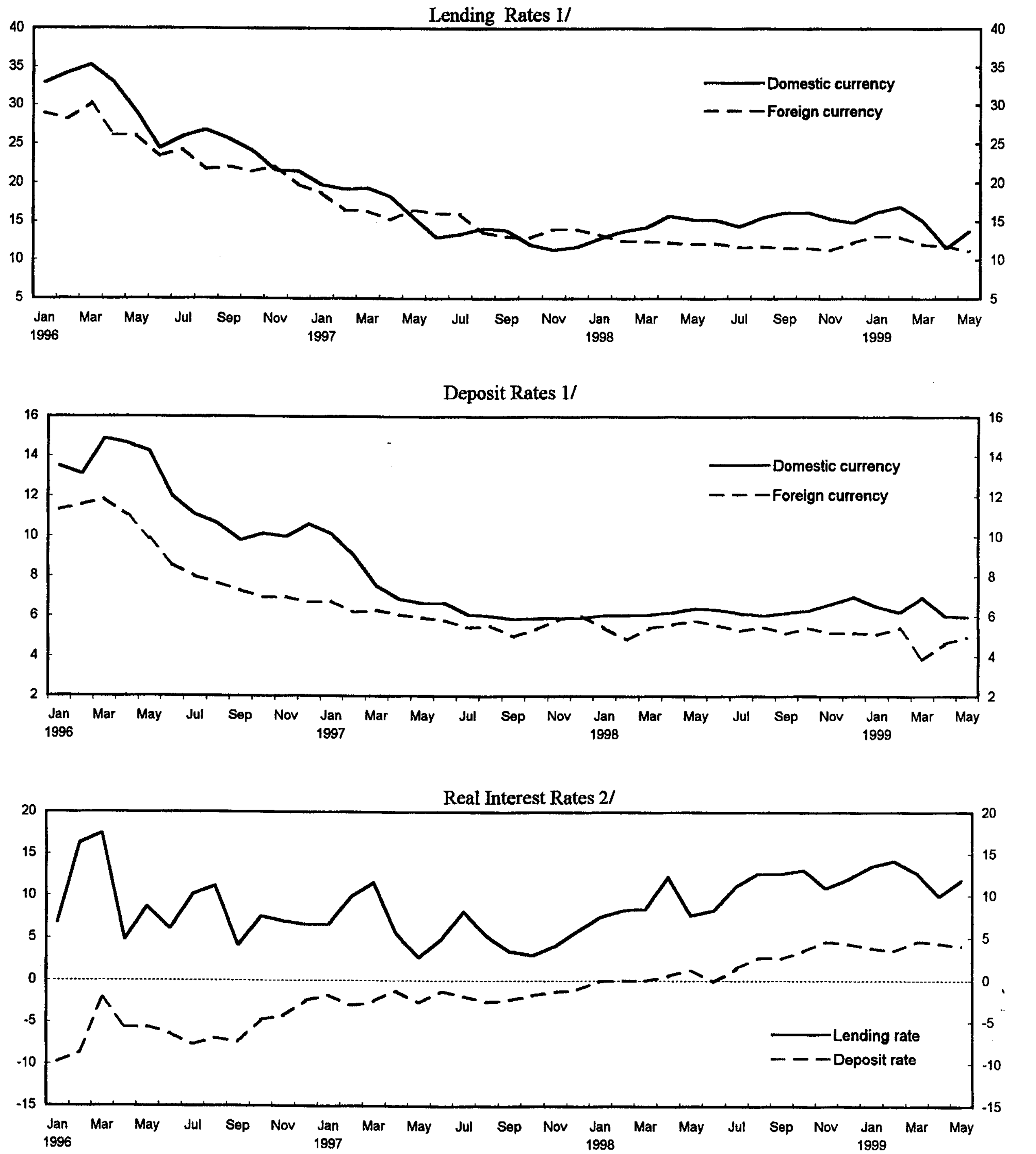
16. The authorities have also continued to strengthen general banking supervision. In part with Fund technical assistance support, new regulations on supervision of bank groups on a

[6] The only remaining exception is the rate of interest on demand deposits.

[7] Collaterals include, inter alia, real estate, inventories, working capital, and growing forest.

[8] These figures exclude banks with suspended operations.

Figure 6. Latvia: Interest Rates, 1996-99
(In percent per annum)



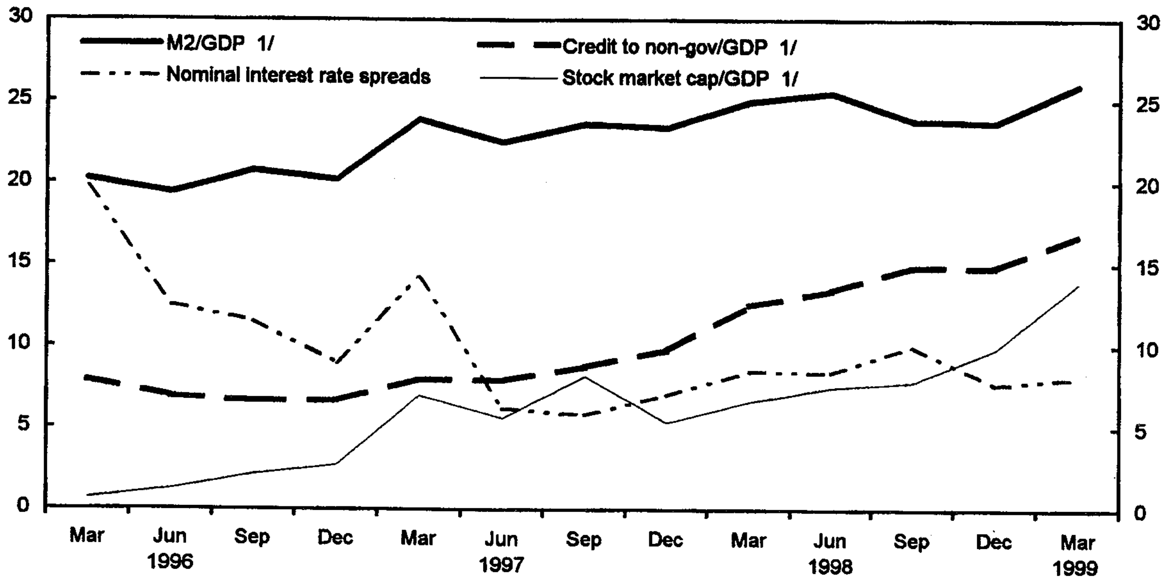
Sources: The Bank of Latvia and Fund staff estimates.

1/ Three-month average; 3-6 months' maturity. Foreign currency deposit and lending rates are primarily denominated in U.S. dollars.

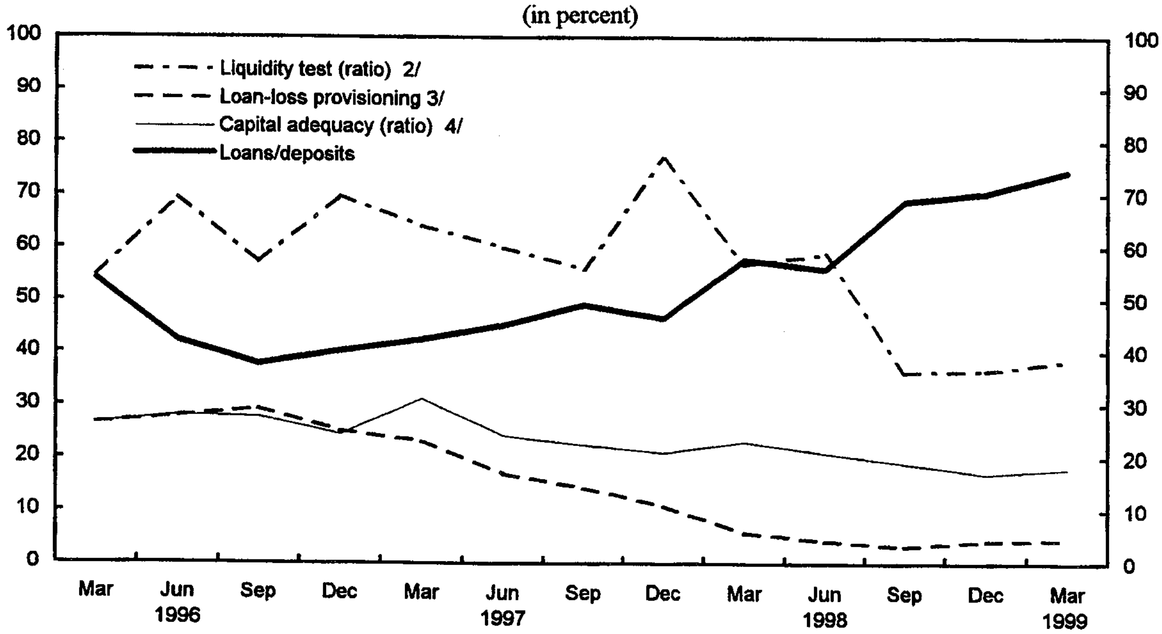
2/ Three-month average, computed using domestic 3-6 month interest rates and twelve month past inflation rate.

Figure 7. Latvia: Financial Sector Developments, 1996-99

Financial Sector Developments Measures
(in percent)



Banking Sector Soundness Variables
(in percent)



Sources: Bank of Latvia, Riga Stock Exchange, and Fund staff estimates.
1/ Q1 1999 GDP is estimated.
2/ Liquidity test is defined as (cash+claims on the cental bank + claims on other credit institutions + fixed income government bonds - liabilities to the central bank - liabilities to other credit institutions) / deposits.
3/ In percent of total loans.
4/ For end-December, based on auditors' reports. Otherwise as reported by banks.

consolidated basis have been introduced, regulations on bank licensing have been revised, and regulations on loan classification and loan-loss provisioning are currently being revised. These measures are part of a broader action plan aimed at ensuring that banking oversight complies with the Basel Core Principles for Effective Banking Supervision (BCP), and with the relevant EU directives. This plan also includes: the introduction of procedural guidelines for the prevention of money laundering; preparation of a draft memorandum of understanding with foreign supervisory counterparts; a comprehensive assessment of banks' management information and internal control systems; introduction of rules for pre-notification of major innovations in banks' activities or major acquisitions and investments; and the signing of a memorandum of understanding on information exchange with domestic financial supervisory counterparts. There are also important ongoing initiatives on the regulation of market, country, and transfer risks. By implementing all these initiatives, the BoL will have moved significantly towards full compliance with the BCP.

17. Development of non-bank financial intermediaries has been supported by improvements in the legal framework, including new legislation on private pension funds, investment funds, and insurance companies. However, insurance companies as well as the Riga Stock Exchange (RSE) were also affected by the Russian crisis. Nevertheless, market capitalization at the RSE increased from 5 percent of GDP at end-1997 to 10 percent at end-1998 (Table 7). A draft law on the creation of a unified financial sector supervisory agency, which would consolidate the BoL's Credit Institutions Supervision Department, the Securities Market Commission, and the Insurance Supervision Inspectorate, is expected to be presented to the Cabinet by July 1999.

18. Latvia has made significant progress in trade liberalization in the last several years, a process that continued in 1998 and 1999 apart from a few reversals, and in February this year, Latvia formally joined the WTO. Most specific import tariffs have been converted to ad valorem tariffs, and all export duties, except on antiques, have been removed. In 1998, a new system of customs valuation was implemented. There have been several tariff reductions thus far in 1999 and only a few increases, most notably a recent temporary increase in the import tariff on pork meat to 70 percent. This increase was in response to allegations of dumping and misreporting of origin of subsidized pork imports. Still, Latvia is rated among the least trade-restricting countries according to the Fund's Index of Trade Restrictiveness. It is simple average tariff declined from 5.9 percent in 1997 to 5.3 percent in 1999 and its tariff dispersion declined from 10.7 to 9.7 during the same period.[9] However, while the production-weighted MFN tariff for agricultural products has been reduced to 34 percent, the commitment under the previous SBA to reduce the average production-weighted tariff for agricultural products, as defined under the program, to 30 percent or less has not yet been met. The relevant legislation has passed the second reading in parliament in June.

19. Recent progress in implementing structural reforms has been mixed, with large-scale privatization lagging while measures to strengthen and improve property rights and the business

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[9] Tariff dispersion is defined as the standard deviation of the tariff rates.

climate have continued (see Table 8 for details on structural reforms). Whereas small and medium-scale enterprise privatization was completed last year, the privatization of several large-scale enterprises has slowed considerably. Concrete plans are now being made to privatize two of the remaining large enterprises, namely the Latvian Shipping Company and Latvenergo, the electricity company, by the end of next year. Apartment privatization is moving ahead though more slowly than originally expected, with 54 percent of all publicly-owned apartments in private hands by early May. Land registration is proceeding, and by early May roughly 240,000 properties (some 43 percent) had been entered in the Land Book. Furthermore, a register for collateral based on movable property became operational in March 1998, facilitating access to credit and reducing borrowing costs; nearly LVL900 million worth of movable property had been registered by early June. Latvia has also made significant strides in addressing administrative barriers to investment and business operations. The authorities maintain as an important objective the accession of Latvia to the European Union (EU), and their structural reform agenda is closely tied to meeting the requirements for accession.

III. Policy Discussions

20. The discussions with the Latvian authorities focused on economic policies for 1999 and the medium term that would limit the current economic slowdown while achieving a sustainable external position, and further the agenda of structural reforms to ensure future sustainable growth. The authorities agreed with the staff on the importance of continuing to pursue sound macroeconomic policies, in particular given the volatile international environment, but feasible actions were limited at this time in the authorities' view. The authorities are also moving forward with plans to increase the efficiency of public spending and tax administration. In addition, they continue to focus on extending and enhancing financial sector oversight, which has taken on increased importance in light of the remaining vulnerabilities in the banking system. Finally, the authorities view the completion of the privatization process—including enterprises, apartments, and land—as crucial to creating a full-fledged market economy.

A. Macroeconomic Framework

21. The medium-term outlook is favorable provided that Latvia maintains a prudent macroeconomic stance and moves toward completing structural reforms. Growth projections have been downgraded in light of the greater-than-expected impact of the Russian financial crisis on the Latvian economy as well as lower growth expectations for key export markets in Europe.[10] Growth is expected to resume in the second half of 1999, supported by a continued expansion of exports to non-CIS markets as well as further healthy investment growth throughout the year. Still, 1999 growth is not likely to exceed 2 percent while the gradual recovery should result in GDP growth of 4 percent in 2000. Continued increases in national savings and investment,

[10] For a more thorough assessment of the negative impact of the Russian economic crisis on the Latvian economy, see Chapter II in the accompanying background paper.

including public investment in core infrastructure, as well as enhanced efficiency arising from structural reforms and foreign direct investment, are expected to generate real GDP growth of 6 percent in the medium term (Table 9). Average inflation is likely to remain below 3 percent in 1999 and over the medium term, as fiscal and monetary restraint is maintained and inflation continues to converge towards the rate of inflation of the euro zone countries. However, increases in administered prices, which so far have outpaced increases in other consumer prices, are likely to keep the rate of inflation slightly above the level currently seen in industrial countries.

22. While gross national savings are expected to decline in 1999, reflecting the fiscal expansion, they are projected to increase considerably over the medium term with further financial development and rising incomes. Savings by the public sector would be substantial as the fiscal position moves toward a surplus. Gross domestic investment is expected to rise by about 1.5 percentage points of GDP over the same period, in part due to rehabilitation and expansion of infrastructure. Privatization of the remaining large-scale companies should also foster greater domestic investment. The external current account deficit is projected to fall gradually to about 5 percent of GDP by 2003.

B. Fiscal Policy and Public Sector Reform

23. The authorities view the original revenue projections for 1999 as optimistic given the strong underperformance during the first four months of the year and the downward revision in the projected real GDP growth rate to around 2 percent. At the same time, the authorities maintain that several expenditure items are not expected to materialize while others, such as interest payments, should be significantly less than budgeted. Therefore, the authorities felt that it should still be possible to achieve the fiscal deficit of 3.8 percent of GDP, as outlined in the budget, without a supplementary budget. To ensure this target, in late May the Minister of Finance announced LVL60 million in spending cuts. At the same time, the authorities are concerned that sharp increases in pension and unemployment benefit expenditures may materialize, which could threaten the Budget Law. The full extent of pension liabilities is still uncertain, mostly due to the relaxation of the benefit calculation rules, which has triggered a wave of applications from recent retirees to recalculate their pensions.

24. Should economic performance remain weak, the staff stated there would be little chance the fiscal deficit could be kept to the target in the Budget Law. However, the staff projects that under a scenario of resumed growth in the second half of 1999 and given the spending cuts announced, an even smaller fiscal deficit of about 2.5 percent of GDP (3.5 percent PAF) could be achieved.[11] But the mission argued that a fiscal deficit of at most 1.2 percent (2.2 percent PAF)

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[11] The authorities expect personal income and social tax revenues to remain relatively weak as many employees may shift to more informal employment arrangements, without social benefits, in order to avoid layoffs. Growing tax arrears and larger-than-expected declines in VAT collections also suggest that an increasing share of activity is taking place outside the formal economy. Latvia, like other advanced transition economies, has experienced a shift from informal to formal

(continued...)

would be more appropriate, taking into account the large external imbalance and continued volatile global environment. Given that consolidated government revenues already amount to some 41 percent of GDP, the staff argued against any new revenue measures.[12] At this time, the authorities were unwilling to commit to spending cuts beyond those needed to ensure a fiscal outcome within the 1999 Budget Law deficit ceiling. Consequently, they were not prepared to consider a supplementary budget, which would have been needed to approach the staff's recommendation.[13] The authorities proposed to revisit the fiscal stance in September, with a primary focus on the 2000 budget, which, they concurred with the staff, should be much closer to balance. By then, the authorities also expect to be in a better position to assess the need for any further spending cuts for 1999, perhaps to be implemented through a supplementary budget.

25. Given Latvia's established reputation for fiscal conservatism, staff expects that, should revenue performance be better than currently projected, the authorities would themselves aim at a smaller deficit than 2.5 percent (3.5 percent PAF) of GDP. Staff also stressed the importance of not letting fiscal expenditures be driven by revenues. In particular, staff argued against pro-cyclical spending cuts during the economic slowdown followed by expenditure increases later in the year when private demand is expected to pick up, which would worsen the external balance.[14]

26. Tax administration reform and modernization of the State Revenue Service continue to progress. The authorities were somewhat concerned that these projects draw resources away from tax enforcement and staff agreed with the authorities on the importance of maintaining adequate staffing for such activities, including tax audits. As to the tax-free and free-trade economic zones, the authorities shared the staff's concern that these zones may be contributing to unjustifiable revenue losses and agreed to continue to monitor the operations of the zones and to clarify and

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activity, a trend that is expected to resume as growth takes off again. Any short-term efforts to increase tax collection from informal activity must avoid being counterproductive by reducing overall economic activity.

[12] Staff estimates that automatic stabilizers account for at least 1 percent of GDP in revenue shortfall and another 0.25-0.5 percent of GDP in increased expenditures. Actual tax revenues have not fallen by this amount due to increases in excise taxes.

[13] Constitutionally, the Minister of Finance may propose spending cuts in the middle of the year if updated revenue projections suggest the deficit target of the Budget Law would not be met. Any spending cuts beyond this could only come through a supplementary budget passed by parliament.

[14] As the authorities underspent significantly in the first quarter of 1999 compared to the budget, the staff is concerned that, if the spending patterns of previous years are followed, spending would increase later in the year, at the time of a projected economic recovery. Given the expected quarterly pattern of annualized growth (Q1=-2.0 percent; Q2=0; Q3=3.8 percent; Q4=6.0 percent), such a fiscal pattern would be very pro-cyclical and may worsen the external balance.

narrow the benefits provided in these zones. Staff also urged establishing a timetable for their phaseout based on a review of their effectiveness; the authorities would consider this later.

27. Furthermore, the mission stressed that, in the medium term, public expenditure will need to be rationalized to improve the efficiency of the public sector and to lower the tax burden. It also urged the government to continue the agenda of public sector administration reform, including the consolidation of government ministries and agencies and the privatization of certain operations. The authorities agreed but stated that further progress in public sector administration would require strong political commitment. Therefore, one member of the Cabinet is to be appointed to be solely responsible for these reforms. Also, a proposal will be presented to the Cabinet concerning a comprehensive national program of public administration reform that would include all levels of government. Finally, staff stressed that further efforts should be made toward establishing a competitive and transparent wage structure for all civil servants to ensure that qualified personnel can be attracted and retained and to reduce incentives for corruption.

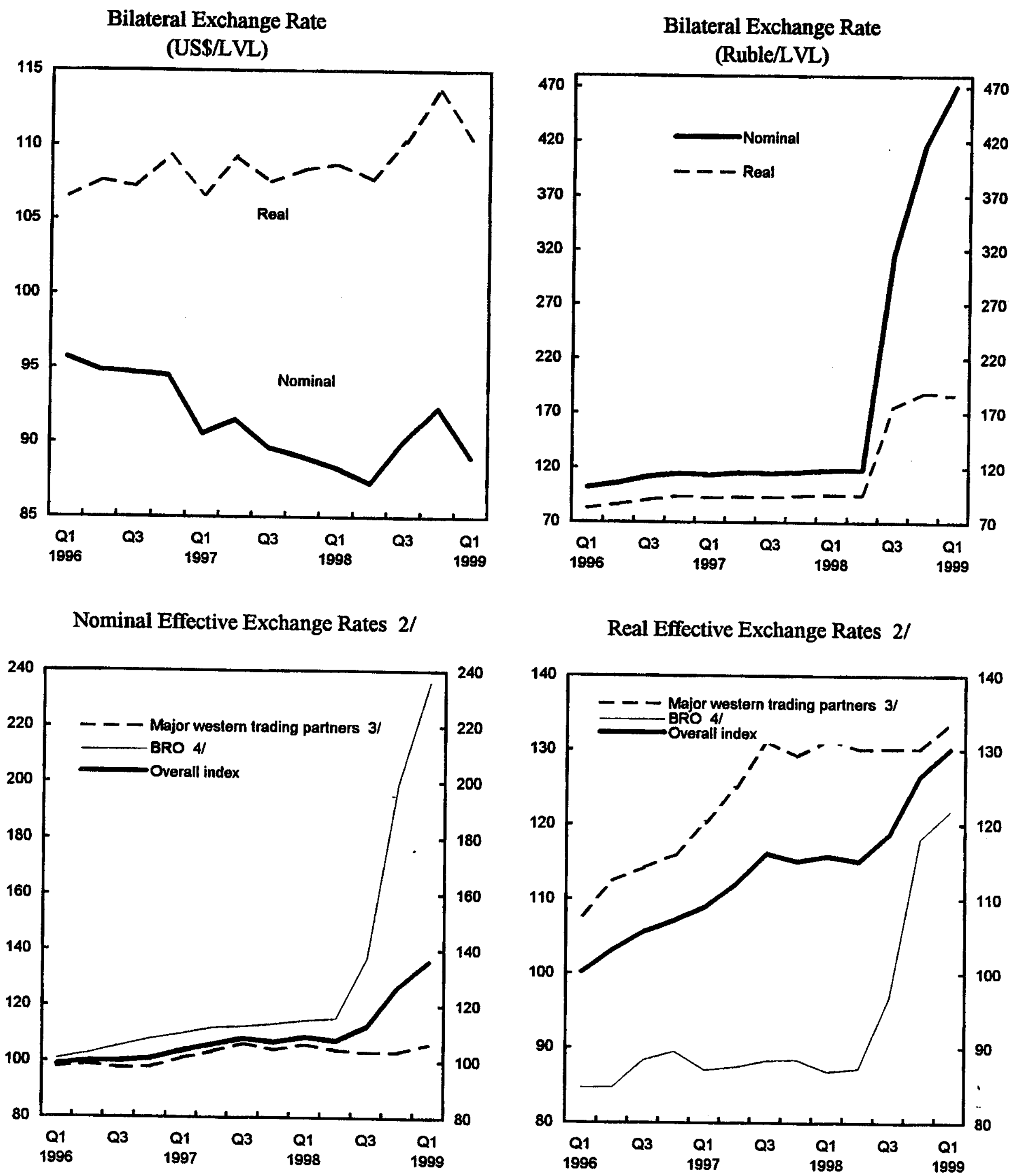
C. Exchange Rate and Monetary Policies

28. Latvia has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund's Articles and at present maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions. The authorities and the staff continue to believe that the exchange rate peg to the SDR has served Latvia well and should continue to do so. Looking forward, while there were minor disagreements between staff and the authorities on the technical appropriateness of an SDR peg versus a euro peg-based on trade patterns and denomination of currencies used for trade, the fundamental medium-term position was similar. Staff encouraged the authorities to start preparing for a switch to a euro peg as their likely accession to the EU approaches. The authorities agreed but underscored that a switch should not occur until the euro gains greater credibility and stabilizes vis-à-vis other major reserve currencies. While the real effective exchange rate appreciated by 18 percent over the last two years (Figure 8), Latvia appears to have maintained its overall external competitiveness and exports to non-CIS countries have continued to grow buoyantly (Box 1).[15]

29. The authorities' monetary program for the remainder of 1999 was discussed. This program assumes a small reduction in velocity and a slight increase in the money multiplier, reflecting a cautious increase in confidence in the economy and banking system, and foresees a 15 percent increase in reserve money and a 17 percent increase in broad money in 1999. The mission agrees with the BoL's intention to maintain its current restrictive monetary policy stance. Nongovernment credit growth is expected to remain subdued in the first half of 1999, reflecting the weaker economy, and to pick up only moderately toward the end of the year, increasing by some 15 percent in nominal terms over the year. Even though there are still no signs of worsening

[15] For a more thorough assessment of Latvia's competitiveness, see Chapter III in the accompanying background paper.

Figure 8. Latvia: Exchange Rates, 1996-99 1/
(1995 = 100)



Sources: IMF, International Financial Statistics, Latvian authorities and Fund staff estimates.

1/ Increase implies an appreciation.

2/ Trade-weighted, using INS-adjusted weights to reflect recent changes in shares of trading partners.

3/ Comprising Denmark, Finland, Germany, the Netherlands, Sweden, U.K., and U.S.

4/ Comprising Belarus, Estonia, Lithuania, the Russian Federation, and Ukraine.

loan portfolios following last year's sharp growth in nongovernment credit, in light of the new risks created by the Russian financial crisis, the authorities agreed they should continue to monitor closely developments in these areas, and stand ready to take rapid action as soon as problems are perceived. Some warning signs, such as the quality of loan portfolios, may appear only with a substantial lag after the credit expansion has reached its peak.

Box 1. Latvia—External Competitiveness Indicators

The analysis of Latvia's external competitiveness suggests that while recently competitiveness may have declined as indicated by an overall appreciation of the real effective exchange rate, recent real appreciation against non-CIS trading partners has been moderate (Figure 8). These partners now represent more than 80 percent of Latvia's trade. Furthermore, some appreciation from usually undervalued levels is expected as long as high productivity growth continues. Hence, by itself, appreciation does not point to a competitiveness problem. Furthermore, other indicators suggest that Latvia remains reasonably competitive.

- While dollar wages in Latvia remain above their levels in many transition economies and overall labor unit costs increased by about 8 percent over the last two years, the increase in unit labor costs in the manufacturing sector was more moderate. This reflects an accumulated productivity growth in manufacturing that has been larger than in most other transition economies, estimated at about 50 percent over the period 1994-1997. In a sample of 12 transition economies, Latvia ranks second as to productivity growth.
- Estimations of equilibrium exchange rates indicate that while Latvia's dollar wages have been converging to an equilibrium level, they still remain below such a level. (See Chapter III in the accompanying background paper.)

Latvia has been upgrading its marketing capability and the quality of its exports with the help of large accumulated foreign direct investment. This has resulted in an increase in its market share in the EU by an accumulated 70 percent over the last three years. In 1998, Latvia's exports to the EU grew by 27 percent. New and "niche" markets have been penetrated in Germany, UK, Sweden, and Denmark, and Latvia has been successful in decisively shifting its exports away from traditional CIS markets. The share of the EU in total Latvian exports is now 56 percent.

D. Financial Sector Reform

30. Notwithstanding the authorities' efforts to enhance banking supervision, the banking system has shown signs of distress as Latvian banks were significantly affected by the Russian crisis. So far, three small banks have been closed while the operations of the insolvent RKB have been suspended (see Box 2). As mentioned above, the suspension of RKB's operations in early March raised public concerns regarding the health of the banking sector as a whole, leading to significant deposit withdrawals from the two largest banks. The mission learned that some banks still have significant residual exposures to Russia, leaving them vulnerable to future defaults by Russia and suggesting the need for further recapitalization. At present, this residual exposure seems to present the most significant downside risk faced by the system.[16] The authorities, recognizing this, intend to continue their vigilant stance.

[16] For further information on the Latvian banking system, see Chapter IV in the accompanying background paper.

Box 2. The Rehabilitation of the Rigas Komercbanka

On May 14, the BoL approved a rehabilitation plan for the RKB involving a sizeable capital injection from the BoL (LVL15.5 million) and contributions from the EBRD (some LVL5.3 million), the Latvian government (LVL1 million), and some of the bank's major creditors and depositors. In addition, the BoL will offer a liquidity guarantee to the bank of (up to LVL18 million), which will constitute an additional contingent liability. The total commitment by the BoL to the rehabilitation process could therefore amount to almost 1 percent of GDP.

The mission raised some questions about the scheme. First, the RKB has made additional losses on residual exposure to Russia in the first quarter of 1999 and has lost important clients and business. Second, under the plan, the Central Bank would (directly or indirectly) become a shareholder in the recapitalized bank, thus creating a potential conflict of interest between the BoL's supervisory activities and its shareholding in RKB. Third, any injection of public funds into the RKB should preferably be directed through the budget and the planned shareholding by the BoL in a rehabilitated RKB should therefore be strictly transitory. Fourth, the plan also raises questions of moral hazard.

The authorities maintained that closing the RKB when the crisis broke out in August-September 1998 could have had dangerous systemic repercussions. Furthermore, since the BoL has already committed significant amounts in liquidity support, they argue that it would be reasonable to attempt to revive the bank. However, the authorities agreed that they should divest their shareholdings in the RKB as soon as possible and have indicated that they envisage to sell the BoL's share in the bank maybe as soon as within six months.

31. In other areas of financial sector supervision, the mission also raised some concerns regarding the draft law on the creation of a unified financial sector supervisory agency. While the mission agreed that this initiative could provide valuable synergies and improve the effectiveness of surveillance and regulatory activities, it noted that a new amalgamated supervisory authority needs to be strictly independent from political interference and should be assured a staff with the same level of competency as is currently exhibited by staff involved in banking supervision. The authorities broadly shared this view.

E. External Sector Policies and Prospects

32. While it is expected that productivity and confidence in the economy will continue to grow with progress in the EU accession process, staff urged the authorities to keep the exchange rate under review. It remains important to monitor carefully developments in the current account, the underlying factors behind these developments, and its financing. The authorities recognize that the exchange rate policy needs to be supported by an appropriate economic policy mix and continued structural reforms, and that they should stand ready, in case of instability in capital flows, to tighten further their monetary and, crucially, fiscal policies.

33. Staff urged the authorities to continue the process of trade liberalization, focussing on reducing the production-weighted agricultural tariff to 30 percent as soon as possible, resisting pressure for further tariff increases, and reducing the number of tariff bands, in particular on the high rates. The recent temporary increase in the tariff on pork meat imports from the already high 38 percent to 70 percent is regrettable. The authorities were of the view that this was in line with

WTO procedures. Staff urged the authorities to consult with the WTO on this and on the adequacy of the new tariff level. In any event, staff remains skeptical about the need for such a high rate of protection and its implications for economic efficiency. Staff also encouraged the authorities to ensure that import licenses continue to be automatic and non-trade restricting. The authorities indicated that they would continue to press for the adoption by parliament of the agricultural tariff reduction. However, while this proposal has passed the first reading, they were concerned about strong resistance in the second reading due to recent dumping allegations. Staff stressed that such concerns, when legitimate, should always be addressed via the WTO safeguards procedures and cautioned the authorities against resorting to such procedures too frequently, urging them to allow the passthrough of international prices to motivate an efficient adjustment in their production structures.

F. Privatization and Other Structural Reforms

34. Latvia's position as a leading reformer among transition economies depends critically on further progress toward completing the structural reform agenda. In particular, while the privatization of small and medium-sized enterprises was completed by mid-1998, progress on large-scale privatization has stalled. The mission stressed the importance of quickly deciding on concrete measures to reinitiate the process in order to signal to both domestic and foreign investors a continued commitment to completing the privatization process. Recently, there have been some new developments in this area, as detailed in Box 3. In particular, privatization plans for the Shipping Company envisaging a sale by end-1999 were approved by mid-May while a new privatization timetable for Latvenergo foreseeing a sale by September 2000 was approved in end-May. While staff would have preferred somewhat earlier steps, they recognize the validity of the authorities' view that at this stage, the quality of privatization is as important as the speed. Meanwhile, negotiations with the current strategic investor in Lattelekom, the telecommunication company, on compensation for limiting the term of the monopoly from 2013 to 2003 suffered a slight setback from the recent ministerial intervention in the setting of telecommunication tariffs.

35. In other areas of structural reform, progress has been more even and the position of staff and the authorities are essentially similar. The government now expects 60 percent of all government-owned apartments to be in private hands by the end of 1999. The slower-than-expected pace of privatization can in part be attributed to delays in preparing apartments for privatization, in particular in the areas of land registration and mapping surveys, as well as uncertainty related to the post-privatization management of apartment buildings. The slowdown in both large-scale enterprise and apartment privatization has implied that roughly 40 percent of initially issued privatization vouchers still remain to be redeemed, and an extension of their validity from end-1999 to end-2000 was recently passed. The authorities expect more than 280,000 properties (some 50 percent) to be registered in the Land Book by the end of the year.

36. Accession to the EU remains a spur to completing structural reforms in Latvia. A detailed work plan on removing administrative barriers to foreign investment was approved by the Cabinet in mid-May. Some of these barriers will be addressed already in 1999, including streamlining procedures for obtaining land property rights, making inspectors' visits and reports more uniform

and transparent, and unifying the duplicative enterprise registration procedures of the Enterprise Register and the State Revenue Service. These reforms should considerably improve the business climate for all investors and should also strengthen governance within the implementing public sector agencies, whose weaknesses in this regard were highlighted in a World Bank 1998 report on corruption in Latvia. In the legal sphere, a new commercial code is expected to be passed by the end of 1999. However, insufficient judicial expertise in commercial law is likely to present a serious obstacle to an efficient implementation of the new law. Finally, the mission discussed with the authorities their preparedness ahead of the Year 2000 computer problem. Both public and private sector institutions are reviewing their computer systems and contingency plans are being drafted. The authorities estimated that the overall risk should be moderate, even though some budgetary organizations and smaller businesses may suffer from lack of funding to address the problems properly. Remaining problems are mainly expected to relate to the vulnerability of utility companies and the financial sector to unresolved problems in some CIS countries.

Box 3. Large-Scale Privatization Plans for 1999 and 2000

- *LASCO.* Privatization terms for the Latvian Shipping Company were approved in May and envision the sale of the company by the end of 1999. The first round of privatization aims to attract a strategic investor who would increase LASCO's share capital by LVL66.7 million through a new share issue. After this initial investment, the strategic investor would purchase 20 million shares in the company at a price of LVL2 per share (the face value of each share is LVL1), rendering an ownership share of approximately 32.5 percent to the strategic investor. During the second round, the remaining state-owned shares are to be sold for vouchers to the public and to employees. The state will retain a golden share in LASCO to ensure that the company and its vessels remain registered in Latvia. However, there are still doubts regarding the feasibility of the privatization plan due to the high minimum share price set by the government, a price that lies considerably above private sector estimates of the company's value.
- *Latvenergo.* A privatization model for Latvenergo was originally agreed by the government in early 1998 but was not executed given the moratorium on the privatization of the company issued by parliament last spring. The passage of an Energy Law that excludes hydropower stations and transmission units from privatization further slowed the process. A new privatization timetable was approved in late May this year, which envisions the determination of sale terms by June 2000 and privatization by September 2000. The government also approved a work plan for restructuring the energy sector, including the liberalization of the electricity market. Still, the debate continues over whether Latvenergo should be sold as a vertically integrated entity or as unbundled units.
- *Lattelekom.* Progress on privatization remains held up by negotiations with the current minority strategic investor (49 percent) over government compensation for the reduction in the monopoly period initially granted to Lattelekom. Limiting the term of the monopoly from the originally envisaged 2013 to 2003 was mandated by the WTO as an accession requirement. The negotiations did not benefit from this spring's ministerial intervention in the setting of telecommunication tariffs and the subsequent dissolution of the telecommunications regulatory agency by the government in response to parliamentary pressure. These actions have generated serious concerns regarding the independence of the regulatory agency. Once compensation terms have been settled with the private investor, the government plans to proceed with a public offer of Lattelekom shares; however, this is not expected until 2000. Parliament is currently working on a new telecommunications law.
- *Air Baltic.* The government retains a majority stake (51 percent) in Air Baltic. Further divestiture will probably not occur in the near future, as several BRO governments grant landing rights only to national (i.e. majority government-owned) airlines.
- *Other.* The Latvian Privatization Agency has announced plans to further divest the state's holdings in Latvijas Gaze and in the oil terminal Ventspils Nafta by the end of 1999. For Latvijas Gaze, the LPA intends to reduce the government share of 39.3 percent to no more than 10 percent. In the case of Ventspils Nafta, of which the government currently owns 49.4 percent, details on further sales have not yet been released. Divestitures in 1999 are expected to raise LVL40-70 million in revenues.

IV. STAFF APPRAISAL

37. Since regaining independence in 1991, Latvia has achieved macroeconomic stability and has made considerable progress toward establishing a market-based economy supported by an efficient public sector. The objectives under the previous program were largely achieved, with the exception of large-scale privatization and agricultural tariff reductions. Continued prudent monetary and fiscal policies in 1998 combined with progress in structural reforms contributed to the overall satisfactory growth performance, despite the adverse impact of the Russian crisis, and to a sharp decline in inflation, which is rapidly approaching industrial country levels. While the external balance worsened significantly last year, it continues to be prudently financed and appears to remain sustainable. In addition, the current account deficit has narrowed significantly in the first quarter of 1999. Rapid private sector credit growth in the beginning of 1998 increased the low level of monetization of the economy and contributed to economic growth without, to date, significant negative effects. Furthermore, strengthened financial sector oversight, enterprise privatization, enhanced property rights, and a constantly improving judicial system have helped lay the foundation for sustainable growth over the medium term.

38. Despite the overall progress achieved in the areas of macroeconomic stability and structural reforms, a number of important risks and challenges remain both in the short and medium term. An immediate challenge is to implement economic policies that limit the slowdown resulting from the Russian crisis and at the same time ensure that the external position remains sustainable. In this context, the staff commends the authorities for their continued restrictive monetary policy stance in face of the crisis, which contributed importantly to maintaining the calm in the financial markets, in particular in the foreign exchange market. The staff also welcomes the rapid reaction by the BoL in the wake of the crisis to further tighten prudential regulations and to immediately extend (collateralized) liquidity support to the banking system.

39. However, the Latvian banking system still manifests important vulnerabilities, in particular remaining significant residual exposures to Russia and lingering risks resulting from past high credit growth. The Russian crisis and the resulting deceleration in the domestic economy have exacerbated these risks. Therefore, the BoL will need to continue to monitor closely the quality of bank loan portfolios and to stand ready to take rapid action should problems emerge. In light of the continued important role to be played by banking supervision, it is therefore important that a consolidated supervisory authority, as suggested by the authorities, be strictly independent from political interference and able to count on competent staff. Furthermore, while staff accepts the authorities' view regarding the importance of extending support to RKB in order to avoid systemic risks to the banking system as a whole, it remains crucial that any shareholding, direct or indirect, by the BoL in the RKB be divested as soon as market conditions allow in order to minimize potential problems of conflict of interest or moral hazard.

40. Fiscal policy has, over the last several years, contributed to lower inflation and interest rates, and provided scope for a marked expansion of credit to the private sector. Notwithstanding the pressures of parliamentary elections, the 1998 fiscal outcome was better than programmed, with the consolidated general government ending the year with a slight surplus. However, looking

ahead, while the staff accepts that a fiscal easing in 1999 compared with the 1998 outcome is called for in light of the economic slowdown, it views the budgetary deficit of 3.8 percent as an easing that could exacerbate the external imbalance. A deficit of at most 2.5 percent of GDP would be more appropriate in light of the continued volatile external environment.[17] Furthermore, given the already high level of government revenues as a share of GDP, the staff is of the view that a fiscal tightening should be realized through expenditure reduction. Finally, the staff would also emphasize the importance of avoiding pro-cyclical fiscal policy, letting expenditures be driven by revenues. In particular, it will be important to avoid expenditure increases later in the year when economic growth is expected to pick up. As to the budget for 2000, at this juncture, a target close to balance would seem desirable.

41. Over the medium term, the authorities will need to accelerate civil service reform and continue pension reform in order to provide room for high priority spending, such as public infrastructure investment, while reducing the tax burden, in particular the very high social insurance contribution rate. In this context, staff welcomes the decision to assign one member of the Cabinet as solely responsible for public sector reforms and to prepare and submit a comprehensive reform program to the Cabinet for approval. Furthermore, the staff continues to stress the need for further efforts toward establishing a competitive and transparent public sector wage structure. Staff also supports the efforts to date in improving tax administration and agree with the authorities on the need to allocate sufficient resources for these reforms. However, staff would urge the authorities to move expeditiously to clarify and narrow the benefits offered under tax-free and free-trade zones and to establish a timetable for their phaseout.

42. The staff agrees with the authorities' view that the exchange rate peg to the SDR, supported by appropriate monetary and fiscal policies, has served Latvia well. While the recent volatility in international financial markets underlined the need for continued close monitoring, there was only limited pressure on the lats exchange rate in the wake of the crisis. Latvia's external position remains largely satisfactory and its competitiveness remains strong, despite the real appreciation vis-à-vis the currencies of the CIS countries. Nevertheless, the staff would continue to stress the importance of closely monitoring indicators of Latvia's external competitiveness and of preparing for an eventual switch to a euro peg in the medium term.

43. The authorities recognize the importance of further reducing agricultural tariffs to benefit consumers and to support the ongoing restructuring of the economy. However, the staff remains concerned that a proposal under the previous SBA to further reduce the average production-weighted agricultural tariff has not yet been passed. At this stage, the authorities should do their utmost to secure the passage of this proposal in the second reading by parliament. Furthermore, the authorities should resist ad hoc tariff increases in response to dumping allegations.

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[17] In the staff appraisal, the fiscal deficit is presented on a PAF basis, which, as stated in the text, results in a deficit about one percentage point greater than on a PAR basis.

44. Further efforts are still needed toward concluding the agenda of structural reforms. At this stage, it is particularly important to overcome the regrettable slowdown in the completion of large-scale enterprise privatization. In this context, staff is encouraged by recent steps taken to further the sales of the remaining two large enterprises. This, supported by the continued enhancement of property rights, would help to establish Latvia firmly as a market economy, attract continued foreign direct investment, and encourage further restructuring both at the corporate level and economy wide. Increased global uncertainty of the last year has further underscored the importance of completing the agenda of second-generation structural reforms. Furthermore, despite the recent ministerial intervention in the setting of telecommunication tariffs, the authorities' proven commitment to market reform should guarantee that an independent regulatory agency is restored expeditiously, paving the way for a successful conclusion of negotiations with the strategic investor on compensation for limiting the monopoly term.

45. Finally, an important remaining challenge facing the Latvian authorities is to improve governance and enhance the business climate. While the staff agrees with the authorities on the general direction of reforms taken in these areas, more rapid progress would have been preferred. In this context, the staff welcomes recent steps to improve the conditions for business operations. While the government also recognizes the importance of strengthening the legal and judicial system, as reflected by plans for a new commercial code, further efforts will be needed to improve judicial expertise in such laws.

46. The periodicity and availability of the most important official statistics for surveillance are adequate, even though some improvements are still needed in certain areas.

47. The authorities have done a commendable job of moving the Latvian economy toward sustainable high-quality growth and full integration into the European economy, including eventual EU accession. In the short-run, the most obvious risks pertain to the impact on the Latvian economy and financial system of the crisis in Russia, both through its effects on the external balance and on the solidity of the banking system. In line with previous governments, the new government formed following last fall's elections has emphasized an early return to a near-balance fiscal position, completion of structural reforms, and integration into western economic and security organizations.

48. It is recommended that the next Article IV Consultation be held on the standard 12-month cycle.

Table 1. Latvia: Observance of Performance Criteria Under the 1997–99 Stand-By Arrangement 1/

Variable and Periods	Target		Outcome	
	(In millions of lats)			
I. Limits on the general government fiscal deficit				
January 1, 1998-March 31,1998: Performance criterion 2/	12		-49	
January 1, 1998-June 30, 1998: Performance criterion 2/	15		-60	
January 1, 1998-September 30, 1998: Performance criterion 2/	15		-70	
January 1, 1998-December 31, 1998: Performance criterion 2/	16		-1	
II. Limits on net domestic assets of the Bank of Latvia				
March 31, 1998: Performance criterion 3/	-3		-30	
June 30, 1998: Performance criterion 3/	-1		-59	
September 30, 1998: Performance criterion 3/	1		-24	
December 31, 1998: Performance criterion 3/	1		8	
III. Floor on net international reserves of the Bank of Latvia	(In millions of U.S. dollars)			
December 31, 1997: Position	734		...	
March 31, 1998: Performance criterion 4/	650		780	
June 30, 1998: Performance criterion 4/	680		880	
September 30, 1998: Performance criterion 4/	728		825	
December 31, 1998: Performance criterion 4/	782		815	
IV. Cumulative limits on contracting and guaranteeing of medium- and long-term non-concessional external debt 5/				
	Total	*Of which* 1-5 year maturity	Total	*Of which* 1-5 year maturity
From June 30, 1997 until				
March 31, 1998: Performance criterion	115	25	108	20
June 30, 1998: Performance criterion	220	25	203	20
September 30, 1998: Performance criterion	250	25	225	20
December 31, 1998: Performance criterion	275	25	270	20
V. Limits on external government debt of up to one year 6/				
March 31, 1998: Performance criterion	0		0	
June 30, 1998: Performance criterion	0		0	
September 30, 1998: Performance criterion	0		0	
December 31, 1998: Performance criterion	0		0	

Table 1. Latvia: Observance of Performance Criteria Under the 1997–99 Stand-By Arrangement 1/

Variable and Periods	Target	Outcome
	(In millions of lats)	
VI. Indicative limits on reserve money		
December 31, 1997: Position	442	...
March 31, 1998: Indicative	455	434
June 30, 1998: Indicative	475	470
September 30, 1998: Indicative	500	457
December 31, 1998: Indicative	537	472
VII. Indicative limits on net domestic assets of the banking system		
December 31, 1997: Position	252	...
March 31, 1998: Indicative 3/	265	272
June 30, 1998: Indicative 3/	312	299
September 30, 1998: Indicative 3/	365	436
December 31, 1998: Indicative 3/	380	508
VIII. Indicative target on central government revenue		
January 1, 1998-March 31,1998: Indicative	210	255
January 1, 1998-June 30, 1998: Indicative	455	514
January 1, 1998-September 30, 1998: Indicative	690	781
January 1, 1998-December 31, 1998: Indicative	965	1034
IX. Structural performance criteria:	by:	
Complete civil service census	end-December 1997	Observed
Complete registration of 140,000 properties in the Land Book	end-December 1997	Waiver granted
X. Structural benchmarks:	by:	
Submit "white paper" on public administration reform to Cabinet	end-March 1998	Observed
Announce the mode of privatization of Latvenergo	end-March 1998	Not observed
Complete privatization of 32 percent of government-owned apartments	end-June 1998	Observed 7/
Sell at least 20 percent of the shares of Latvian Shipping Company (including to a strategic investor)	end-June 1998	Not observed
Reduce the government's share in Ventspils Nafta to less than 50 percent	end-June 1998	Observed 7/
Complete registration of 160,000 properties in the Land Book	end-June 1998	Observed

1/ Definitions of the performance criteria and indicative limits and targets are included in the Annexes to the Letter of Intent dated March 9, 1998. In addition to the performance criteria specified in the table, a continuous performance criterion respecting the non-accumulation of external arrears by the government applies.

2/ The ceiling will be adjusted upward for any excess of disbursements of foreign assistance for the PIP from the programmed amounts, and downward for any excess of privatization revenue from the programmed amount.

3/ The ceiling will be adjusted upward for any shortfall of disbursements of foreign balance of payments assistance from the programmed level.

4/ The floor will be adjusted downward for a shortfall in disbursements of foreign balance of payments assistance from the programmed level.

5/ Applies to the government, the Bank of Latvia, or any other agencies on behalf of the government.

6/ Applies to debt outstanding or guaranteed by the government, excluding normal import-related trade credits.

7/ The benchmark was met with a delay of up to one month.

Table 2. Latvia: Selected Economic and Financial Indicators, 1995–99

	1995	1996	1997	1998	1999-Q1 Prel. est. 1/	1999 Staff proj.
	(Annual percentage changes unless otherwise specified)					
National income						
Nominal GDP (millions of lats)	2,349	2,829	3,275	3,774	884	3,949
GDP (millions of $US)	4,453	5,137	5,639	6,398	1,508	6,682
Real GDP (change in percent)	-0.8	3.3	8.6	3.6	-2.0	2.0
Prices and wages (change in percent)						
Consumer price index, period average	25.1	17.6	8.0	4.7	2.6	2.5
Consumer price index, end-period	23.1	13.1	7.0	2.8	2.3	3.1
Real wage	-1.1	-5.3	11.2	6.2	5.0	...
Average monthly wage (level in lats)	90	99	120	133	133	...
Average monthly wage (level in $US)			207	225	229	...
General government (in percent of GDP)						
Revenue 2/	37.2	38.0	39.3	40.6	41.7	40.5
Expenditure	40.5	39.5	38.9	41.2	42.1	43.3
Financial balance 2/	-3.3	-1.5	0.4	-0.7	-0.4	-2.9
Net lending	0.6	0.2	0.3	0.1	0.4	0.6
Fiscal balance 2/	-3.9	-1.7	0.1	-0.8	-0.8	-3.5
External sector (change in percent) 3/						
Exports (goods and nonfactor services)						
Value	32	28	9	8	-10	2.8
Volume	7	9	20	11	...	3.0
Imports (goods and nonfactor services)						
Value	47	30	11	17	-12	0.8
Volume	24	23	16	16	...	-3.0
Terms of trade	8	-2	-5	-4	...	-0.4
External trade balance (percent of GDP) 4/	-13.0	-15.5	-15.3	-17.7	-10.3	-16.5
Current account balance (including official transfers, percent of GDP)	-3.6	-4.2	-5.1	-9.5	-2.5	-8.4
International reserves (in months of imports of goods and nonfactor services, end-of-period)	3.0	3.1	3.0	2.7	2.7	3.0
Exchange rate (lats per $US; end-of-period)	0.537	0.556	0.590	0.569	0.590	0.591
Money and credit (end-period, change in percent) 5/						
Reserve money	2	25	30	7	11	15
Domestic credit (non-government)	-45	1	76	51	35	15
Broad money	3	20	39	6	5	17
Broad money to NFA of the BoL, level	2.4	1.8	2.0	2.0	1.9	1.9
Interest rates (in percent, per annum, end-period)						
Deposit 6/	13	11	6	7	7	...
Credit 6/	35	20	13	15	15	...
One-month treasury bill auction rate	30.1	10.1	3.5	6.3	6.5	...

Sources: Latvian authorities; and Fund staff estimates and projections.

1/ Staff projection in the case of GDP data and where ratios to GDP are shown.

2/ Privatization receipts are classified as a deficit financing component, i.e. they are excluded from revenues.

3/ Goods and nonfactor services, in $US terms. 1997 data are inconsistent with earlier periods due to recent revisions.

4/ Goods only.

5/ Figures for 1995 and 1996 exclude assets and liabilities of insolvent banks which were removed from monetary data in December 1995.

6/ Average volume-weighted commercial bank interest rates on 3-6 month domestic currency transactions.

Table 3. Latvia - Illustrative Scenario: Balance of Payments, 1996-2004

	1996	1997	1998	1999					2000	2001	2002	2003	2004
				Q1	Q2	Q3	Q4	Year					
				Proj. 1/		Proj.					Proj.		
	(In millions of U.S. dollars)												
Current account balance	-217	-287	-608	-38	-95	-186	-238	-558	-555	-492	-466	-462	-466
excluding Official transfers	-276	-329	-661	-48	-105	-196	-248	-598	-595	-532	-506	-502	-506
Trade Balance	-798	-848	-1,130	-157	-205	-309	-426	-1,098	-1,150	-1,114	-1,109	-1,127	-1,164
Exports, f.o.b.	1,488	1,838	2,011	466	517	535	534	2,051	2,429	2,780	3,155	3,547	3,958
Imports, f.o.b.	-2,286	-2,686	-3,141	-624	-722	-844	-960	-3,150	-3,579	-3,894	-4,264	-4,673	-5,122
Services,income & transfers balance	581	560	523	119	110	124	188	540	595	621	644	664	698
Of which:													
Transport sector, net	533	515	488	126	122	102	138	488	529	538	544	549	572
Travel, net	-94	-76	-69	-15	-33	-19	-5	-71	-74	-76	-79	-81	-83
Interest, net	3	14	12	-16	0	12	17	13	16	17	18	19	16
Other income	39	40	41	10	14	9	10	42	50	58	66	74	83
Other services	9	-11	-35	-15	-26	-9	18	-32	-26	-15	-6	3	10
Current transfers, net	98	77	85	25	21	28	26	100	100	100	100	100	100
Capital account balance	548	361	578	56	249	154	255	713	684	801	791	782	626
Capital transfers	0	14	10	0	0	0	0	0	0	0	0	0	0
Foreign investment , net	238	-57	226	25	25	85	175	310	440	540	540	540	540
Foreign direct investment, net	379	515	220	...	...	...	...	310	420	520	520	520	520
FDI in Latvia	382	521	274	...	...	...	...	320	450	550	550	550	550
Direct investment abroad	-3	-6	-54	...	...	...	...	-10	-30	-30	-30	-30	-30
Portfolio investment, net	-141	-572	6	...	...	...	...	0	20	20	20	20	20
Other medium and long-term capital	57	165	201	29	204	46	72	351	214	231	221	212	56
Government, net	45	20	45	4	174	-4	17	191	54	71	61	52	-104
Other sectors, net	13	145	156	25	30	50	55	160	160	160	160	160	160
Other capital and investment, net	253	239	140	0	0	23	8	30	30	30	30	30	30
Errors and omissions	-109	29	92	2	20	0	0	22	0	0	0	0	0
Overall balance	222	102	63	17	153	-32	16	155	129	309	325	320	160
Financing items:	-222	-102	-63	-17	-153	32	-16	-155	-129	-309	-325	-320	-160
Change in NFA, total	-211	-102	-63	-17	-153	32	-16	-155	-129	-309	-325	-320	-160
Official NIR (increase,-)	-211	-102	-63	-17	-153	32	-16	-155	-129	-309	-325	-320	-160
Gross convertible reserves	-186	-65	-38	-13	-148	35	-14	-140	-118	-299	-315	-309	-160
Use of Fund credit net	-25	-37	-25	-4	-6	-3	-3	-15	-10	-10	-10	-10	0
Natural gas arrears	-11	0	0	0	0	0	0	0	0	0	0	0	0
	(In percent of GDP unless otherwise stated)												
Current account balance	-4.2	-5.1	-9.5	...	...	...	...	-8.4	-7.7	-6.4	-5.7	-5.3	-5.0
Curr.acc.balance excl. official transfers	-5.4	-5.8	-10.3	...	...	...	...	-9.0	-8.3	-6.9	-6.2	-5.7	-5.4
Trade balance	-15.5	-15.0	-17.7	...	...	...	...	-16.5	-16.0	-14.5	-13.5	-12.8	-12.4
Exports	29.0	32.6	31.5	...	...	...	...	30.7	33.9	36.2	38.4	40.4	42.1
Imports	44.5	47.6	49.1	...	...	...	...	47.2	49.9	50.7	51.9	53.2	54.5
Services, income & transfers balance	11.3	9.9	8.2	...	...	...	...	8.1	8.3	8.1	7.8	7.6	7.4
Gross official reserves (millions of US$)	772.5	837.9	875.8	889.1	1,036.8	1,001.8	1,015.8	1,015.8	1,134.1	1,432.7	1,747.7	2,056.9	2,217.1
in months of GNFS imports	3.1	3.0	2.7	2.7	3.1	3.0	3.0	3.0	3.1	3.6	4.0	4.3	4.2
Volume growth of goods exports (percent)	8.9	20.2	11.3	...	...	...	...	2.8	14.9	12.2	11.2	10.2	10.2
Volume growth of goods imports (percent)	22.7	15.5	15.6	...	...	...	...	-3.0	9.0	8.9	8.4	8.2	8.2
Value growth of imports of GNFS (percent)	38.0	10.6	16.5	...	...	...	...	0.8	13.1	8.7	9.3	9.4	9.4
Value growth of exports of GNFS (percent)	28.3	9.4	7.8	...	...	...	...	2.0	15.7	11.8	11.2	10.6	10.4
FDI stock	15.4	13.0	15.0	...	...	...	...	19.0	23.8	29.3	34.0	37.9	41.2
External public debt stock, eop (millions of US$) 2/	432.1	417.4	471.9	...	...	...	...	698.6	724.7	766.4	805.4	882.3	802.9
in percent of GDP 2/	8.4	7.4	7.4	...	...	...	...	10.5	10.1	10.0	9.8	10.0	8.5
Public debt service (in percent of exports) 2/	4.4	7.0	3.8	...	...	...	...	3.8	5.5	3.8	3.8	3.7	7.1
Total external debt (in millions of US$)	726.6	775.7	1,080.9	...	...	...	...	...	...	...	...	...	...
in percent of GDP	14.2	13.8	16.9	...	...	...	...	...	...	...	...	...	...

Sources: Data provided by Latvian authorities; and staff estimates.

1/ Except merchandize trade, for which the data are preliminary.

2/ Includes private publicly guarnateed debt.

Table 4. Latvia: Consolidated General Government, 1995-99

	1995	1996	1997	1998	1999			1998	1999
					Budget	Staff Proj.	Active 1/	Q1	Q1
					(in millions of lats)				
Revenue 2/	874.9	1,075.8	1,288.4	1,530.4	1,654.9	1,598.0	1,598.0	361.0	368.3
Tax revenue	772.2	953.6	1,113.7	1,293.2	1,407.2	1,327.7	1,327.7	307.8	307.1
Direct taxes	465.8	541.9	646.0	739.5	806.9	773.4	773.4	170.8	184.1
Corporate income tax	47.5	57.4	78.6	92.4	90.9	82.3	82.3	22.3	24.3
Personal income tax	126.8	156.6	183.5	219.7	243.4	242.5	242.5	49.6	57.7
Social security tax	291.4	327.9	383.9	427.4	472.6	448.6	448.6	98.9	102.1
Indirect taxes	306.5	411.7	467.6	553.8	600.4	554.3	554.3	137.0	123.0
Taxes on goods & services	280.6	379.3	430.5	505.5	557.7	511.6	511.6	124.7	112.6
VAT	219.9	267.7	288.5	316.3	345.8	307.3	307.3	82.7	75.3
Excise (central & special budgets)	42.5	93.0	119.9	169.5	193.3	186.6	186.6	36.9	33.6
Customs duty	18.3	18.7	22.0	19.8	18.6	17.6	17.6	5.1	3.6
Property taxes	25.8	32.3	37.2	48.3	42.7	42.7	42.7	12.3	10.4
Real estate tax	10.8	13.4	16.9	18.0	42.7	37.2	37.2	3.3	4.9
Property tax	15.1	19.0	20.3	27.4	...	5.0	5.0	7.8	5.0
Land tax	0.0	0.0	0.0	2.9	...	0.5	0.5	1.2	0.5
Non-tax revenue	102.6	122.2	174.8	237.2	247.7	270.3	270.3	53.1	61.1
Expenditure	952.0	1,118.4	1,275.0	1,556.6	1,754.8	1,711.7	1,665.3	319.8	371.9
Current expenditure: *of which:*	852.2	1,040.2	1,011.6	1,411.1	1,599.5	1,568.5	1,554.1	307.0	354.6
Wages & salaries	209.4	256.9	277.7	355.1	383.8	392.8	386.6	70.0	87.8
of which: Social security contributions	38.5	43.3	49.8	74.6	78.4	81.3	80.8	15.4	18.8
Goods & services	214.9	248.4	256.4	307.3	321.1	311.7	306.7	74.3	71.0
Interest	28.8	48.9	33.8	27.5	46.5	29.9	28.7	8.2	5.8
Subsidies & transfers	399.0	486.0	443.8	706.4	848.2	834.0	832.0	153.0	189.9
Transfers to households	408.3	477.1	455.3	537.5	634.0	633.4	633.4	116.0	154.0
Other	...	8.9	14.2	168.9	214.2	200.7	198.7	40.8	36.0
Capital expenditure	21.5	51.0	81.3	145.4	155.3	143.1	111.2	12.8	17.3
of which: Investment	...	0.0	32.2	90.4	97.7	76.0	55.0	6.8	10.9
Financial balance	-77.1	-42.6	13.4	-26.1	-99.8	-113.7	-67.3	41.2	-3.7
Net lending (+)	15.0	5.0	10.0	2.6	52.0	24.8	19.8	0.8	3.5
Fiscal balance	-92.1	-47.6	3.4	-28.7	-151.8	-138.5	-87.1	40.4	-7.2
(Fiscal balance inclusive of priv. receipts)	-83.0	-39.6	45.0	8.1	-112.0	-98.6	-47.2	42.3	-7.1
Financing	92.1	47.6	-3.4	28.7	151.8	138.5	87.1	-40.4	7.2
Privatization receipts	9.1	8.0	41.5	36.8	39.8	39.8	39.8	1.8	0.0
Domestic	51.0	27.6	-50.9	-21.2	46.5	1.6	-49.8	-41.6	10.0
Banks	49.0	15.6	-45.0	5.1	-3.2	-16.9	-68.3	-15.8	-8.5
Other domestic	2.0	12.0	-5.9	-26.3	49.7	18.5	18.5	-25.8	18.5
Foreign	32.0	12.0	6.0	13.1	65.5	97.1	97.1	-0.7	-2.9
Memorandum items									
					(in percent of GDP)				
Revenue (net of privatization)	37.2	38.0	39.3	40.6	41.9	40.5	40.5	41.1	41.7
Expenditure	40.5	39.5	38.9	41.2	44.4	43.3	42.2	36.4	42.1
Net lending	0.6	0.2	0.3	0.1	1.3	0.6	0.5	0.1	0.4
Fiscal balance	-3.9	-1.7	0.1	-0.8	-3.8	-3.5	-2.2	4.6	-0.8
(Fiscal balance inclusive of priv. receipts)	-3.5	-1.4	1.4	0.2	-2.8	-2.5	-1.2	4.8	-0.8
					(in percent)				
Growth rate of revenue	18.6	23.0	19.8	18.8	8.1	4.4	4.4	27.0	2.0
Growth rate of expenditure	22.1	17.5	14.0	22.1	12.7	10.0	7.0	13.0	16.3
Nominal GDP (millions of lats)	2,349	2,829	3,276	3,774	3,949	3,949	3,949	879	884

Sources: Ministry of Finance; and Fund staff estimates.

1/ Active policy assumes a reduction of the fiscal deficit through additional spending cuts to 2.2 percent of the projected GDP.

2/ Revenues exclude receipts from privatization, unless otherwise noted.

Table 5. Latvia: Reserve Money and Net Domestic Assets of the Bank of Latvia, 1995-99
(in millions of lats)

	1995	1996				1997				1998				1999		1999
							New Acct. 1/									Staff Proj.
	Dec.	March	June	Sept.	Dec.	March	June	Sept	Dec	Mar	Jun	Sept	Dec	Mar	May	Dec
Reserve money	270.3	261.4	311.0	309.7	340.7	350.0	370.9	388.6	420.3	433.9	470.5	457.4	471.5	481.0	476.3	543.9
Currency in circulation	225.9	224.7	244.0	261.0	282.6	291.8	310.0	327.7	359.4	357.2	380.5	374.0	374.4	393.4	395.9	440.6
Bank deposits	44.5	36.8	67.0	48.7	58.1	58.2	60.9	60.9	60.9	76.7	90.0	83.4	97.0	87.6	80.4	103.3
Foreign currency deposits	--	--	11.6	12.5	6.8	8.3	3.1	0.1	0.1	--	--	--	--	--	--	--
Other	44.5	36.8	55.4	36.2	51.3	49.9	56.9	60.8	60.8	76.7	90.0	83.4	97.0	87.6	80.4	103.3
Net foreign assets 2/ 3/	221.0	242.7	280.3	304.1	349.4	357.5	391.0	426.0	433.1	463.8	529.7	480.9	463.9	488.5	568.3	572.6
Net International Reserves 1/	226.9	248.8	286.3	309.4	354.6	362.6	396.1	431.0	438.2	462.7	528.6	480.4	463.6	488.2	568.1	572.3
Correspondent accounts 1/ 2/	-5.8	-6.1	-6.0	-5.3	-5.2	-5.1	-5.1	-5.1	-5.1	1.1	1.1	0.5	0.3	0.3	0.3	0.3
Net domestic assets	49.3	18.7	30.7	5.6	-8.7	-7.5	-21.0	-37.4	-12.8	-30.0	-59.2	-23.5	7.6	-7.4	-92.0	-28.7
Domestic credit	100.3	73.2	86.9	62.6	43.3	52.3	47.8	30.4	83.0	47.9	44.9	84.6	113.8	100.8	13.6	79.3
Banks	43.5	46.6	40.4	30.7	10.0	28.4	6.3	1.1	7.6	10.3	13.0	33.4	52.0	84.0	53.5	69.1
BoP assistance	39.9	40.1	37.1	28.1	5.6	24.0	3.0	0.6	0.6	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Refinance credits	3.5	6.5	3.3	2.6	4.3	4.4	3.3	0.5	6.9	10.1	12.9	33.3	51.9	83.9	53.4	69.0
Government,net 4/	56.9	26.6	46.5	31.9	33.3	23.9	41.5	29.3	75.5	37.6	31.9	51.2	61.7	16.8	-39.9	10.2
BoP assistance	35.8	34.5	34.1	37.1	50.3	42.4	59.8	60.7	59.4	59.2	60.7	55.8	54.3	55.6	56.2	50.0
Other government,net 5/	21.0	-7.9	12.4	-5.2	-16.9	-18.4	-18.3	-31.4	16.1	-21.6	-28.7	-4.6	7.4	-38.7	-96.0	-39.8
Other items, net	-51.0	-54.5	-56.2	-57.0	-52.0	-59.8	-68.8	-67.8	-95.9	-77.8	-104.1	-108.1	-106.2	-108.2	-105.6	-108.0
Memorandum Items:																
						Percentage change from previous quarter										
Reserve money	3.6	-3.3	18.9	-0.4	10.0	2.7	5.7	5.0	8.2	3.2	8.4	-2.8	3.1	2.0	-1.0	3.8
Domestic credit	19.1	-27.0	18.6	-28.0	-30.8	15.5	-8.7	-39.2	173.3	-42.3	-6.2	88.3	34.5	-11.4	-86.5	14.7
Banks	-3.4	7.3	-13.3	-23.9	-67.6	-4.3	-77.8	-95.2	579.0	35.9	26.3	157.4	56.0	61.4	-36.3	13.9
Government,net 4/	44.7	-53.2	74.6	-31.5	4.6	53.1	73.3	9.7	157.9	-50.2	-15.1	60.3	20.5	-72.8	-337.213	20.0
Exchange rate (LVL/US$)	0.537	0.549	0.554	0.555	0.556	0.580	0.574	0.586	0.590	0.595	0.602	0.583	0.569	0.590	0.597	0.591
NFA total (US$mn)	422.5	453.1	516.7	557.5	637.8	625.1	690.1	726.9	734.0	779.5	879.9	824.9	815.2	827.9	952.0	968.9

Sources: Bank of Latvia; and staff estimates.

1/ New accounting to include changes instituted in June 1997 by the BOL and is a break in series.

2/ Valued at current exchange rates.

3/ As the Bank of Latvia has almost no medium- and long-term foreign currency liabilities, NFA equals NIR.

4/ Excluding proceeds from foreign loans for balance of payments support.

5/ Includes purchase of Treasury bills.

Table 6. Latvia: Monetary Survey and Net Domestic Assets of the Banking System
(in millions of lats)

	1995	1996				1997				1998				1999		1999
							NewAcct.1/									Staff Proj.
	Dec. adj.	March	June	Sept	Dec.	March	June	Sept	Dec	Mar	June	Sept	Dec	Mar	May	Dec
Broad money (M2X)	524	504	544	601	628	654	724	805	871	879	975	921	923	920	928	1,081
Currency held by public	210	212	230	244	264	274	286	304	333	332	352	344	340	358	360	403
Household deposits	65	61	63	64	67	71	76	86	96	104	114	111	118	109	111	131
Enterprise deposits	95	80	84	95	104	98	133	148	170	173	211	197	200	195	206	244
Residents' FC deposits 2/	154	152	168	198	193	211	229	267	272	271	298	269	264	259	252	303
Total deposits	314	293	314	357	364	380	438	501	538	547	623	577	583	563	569	678
Net foreign assets (total) 3/	300	318	368	403	445	457	548	619	619	606	676	485	415	416	475	509
OECD currencies	287	277	336	397	440	436	450	493	512	459	534	509	501	497	559	590
Non-OECD currencies	13	41	32	6	5	21	98	126	107	148	142	-24	-86	-81	-84	-81
Net domestic assets	224	186	177	199	183	197	177	186	252	272	299	436	508	504	453	572
Domestic credit	332	311	333	348	366	371	390	428	479	495	538	584	647	676	615	742
Households	28	26	25	25	21	23	25	31	37	43	52	58	64	70	74	78
Enterprises	176	171	168	168	185	196	230	267	327	397	460	517	513	527	527	587
Government, net	127	113	139	156	160	152	135	129	115	54	27	9	70	79	14	77
Restructuring Bonds	61	54	54	53	53	33	33	32	24	24	24	24	24	24	24	24
Other Credit to Government	66	59	86	102	107	119	102	97	91	30	3	-15	46	55	-10	53
Other items, net	-108	-125	-156	-150	-183	-173	-214	-242	-227	-222	-239	-148	-140	-172	-162	-170
Memorandum Items:																
	Percentage change from previous quarter															
Broad money(M2X)	-19	-4	8	10	4	4	11	11	8	1	11	-6	0	0	1	5
Domestic credit	-33	-6	7	5	5	6	5	14	12	3	9	9	11	4	-9	5
Households	-34	-6	-4	-1	-15	7	8	27	17	19	19	13	10	9	7	5
Enterprises	-50	-3	-2	0	10	6	18	16	22	21	16	12	-1	3	0	5
Other credit to Government	59	-11	46	20	4	33	-14	11	-6	-67	-91	-699	-400	20	-118	8
Exchange rate (LVL/US$)	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1
Total NFA (US$mn) 3/																
Total	558	580	664	726	800	788	955	1,057	1,049	1,019	1,123	832	729	706	796	862
of which: comm. banks	147	138	158	178	172	171	273	330	315	240	243	8	-86	-122	-156	-107

Sources: Bank of Latvia; and Fund staff estimates.

1/ Revised data include accounting changes that began in June 1997 and represent a break in series.

2/ As of June 1997, residents' foreign currency deposits are deposits in all currencies except lats.

Table 7. Latvia: Selected Financial Indicators, Quarterly 1996-99

(in percent unless otherwise indicated)

	1996				1997				1998				1999
	March	June	Sept.	Dec.	March	June	Sept.	Dec.	March	June	Sept.	Dec.	March
Net foreign assets of the BoL, in millions of U.S. dollars	453	517	558	638	625	690	727	734	780	880	825	815	828
Net foreign assets of commercial banks, in millions of U.S. dollars	138	158	178	172	171	273	330	315	240	243	8	-86	-122
Commercial banks total reserves/total deposits	15.6	17.1	15.3	15.8	16.5	16.3	16.4	16.3	15.8	15.5	18.2	16.1	15.9
Commercial banks excess reserves/total reserves	11.8	12.1	10.6	15.9	12.1	21.1	17.9	18.8	11.4	11.2	18.1	19.3	13.7
Loans/deposits	53.9	42.2	37.7	40.2	42.3	45.1	49.0	46.4	57.6	55.9	66.8	70.3	74.4
Loans/total assets	31.9	24.9	22.9	23.7	24.5	25.9	26.2	29.7	34.6	34.6	42.4	43.4	41.8
Credit to nongovernment/GDP 1/	7.9	6.9	6.6	6.6	8.0	7.9	8.7	9.8	12.5	13.4	14.9	14.8	16.9
NFA of BoL/ Broad Money	0.48	0.51	0.51	0.56	0.55	0.55	0.53	0.50	0.53	0.54	0.52	0.50	0.53
Liquidity test 2/	54.5	69.5	57.1	69.7	64.0	59.9	55.9	77.0	56.7	58.8	36.3	36.6	38.5
Capital adequacy -- risk-weighted average 3/	26.5	28.1	27.7	24.5	31.1	24.3	22.4	21.0	23.0	21.0	18.0	17.0	18.0
Loan-loss provisioning/gross loans	26.5	27.9	29.3	25.1	23.2	17.0	14.4	11.0	5.9	4.3	3.3	4.3	4.5
Return on equity 4/	41.0	30.0	21.0	24.0	24.0	26.0	29.0	26.0	17.0	15.0	-5.8	-12.9	19.8
Net portfolio investments/NFA 5/	0.5	0.4	0.8	1.6	-3.3	0.6	-0.2	-1.1	-5.5	2.2	3.6	1.0	...
Net foreign asset position 6/	179.3	263.4	263.1	349.3	290.2	298.6	292.9	310.5	171.4	188.2	85.9	152.4	111.1
Nominal interest rate spread 7/	20.4	12.4	15.8	10.9	11.8	6.1	7.9	5.7	8.1	8.8	9.9	7.9	9.5
Stock market index, level 8/	100.0	154.9	201.3	247.7	469.1	383.6	476.6	345.9	306.3	206.8	113.5	98.0	81.9
Stock market capitalization/GDP 1/	0.6	1.2	2.1	2.7	7.0	5.6	8.2	5.3	6.6	7.5	7.8	9.8	13.9

Sources: Bank of Latvia; Fund staff estimates.

1/ GDP is calculated using annualized quarterly data. Q1 1999 GDP is estimated.

2/ Liquidity test is defined as: (cash + claims on the central bank + claims on other credit institutions + fixed-income government bonds - liabilities to the central bank - liabilities to other credit institutions) / deposits.

3/ End-December values based on audited financial statements; otherwise, as reported by banks.

4/ Return on equity is defined as the ratio of the value of bank-issued equity to profits.

5/ Portfolio investments are defined as holdings less than or equal to 10 percent of total assets; NFA of total banking system. Banking sector data excluded prior to 1998.

6/ Net foreign asset position vis-à-vis foreign credit institutions, in LVL millions.

7/ Commercial bank lending-deposit spreads for 3-month average of 3-6 months' maturities.

8/ Dow Jones Riga stock exchange index, end-of-period data.

Table 8. Latvia: Status of Structural Reforms

Measure	Description and Status of June 1999
I. Fiscal Management	
Tax Administration	In early 1998 the collection of social taxes was moved from the Social Fund to the State Revenue Service (SRS). Enhanced computerization, implemented through a five-year plan with the World Bank, will further improve tax administration. A first priority is customs administration and a pilot project of the implementation of ASYCUDA took place in 1998, to be fully implemented in 1999. An SRS Modernization Project, launched with the assistance of the World Bank in December 1998, further aims to strengthen the overall institutional effectiveness and the technical performance of the SRS. Recent missions urged the authorities to review the operations of tax-free and free-trade economic zones in the context of their effectiveness in fostering regional development and the associated cost in terms of revenue loss. They also encouraged the authorities to tighten zone rules to limit tax revenue losses and to commit to not create any new zones.
Review of current expenditure	A civil service census was completed in December 1997 and a "white paper" on public sector reorganization and civil service reform was approved in July 1998. Draft civil service legislation should be completed by February 1999. Internal audits of ministries were carried out during November 1998-February 1999, and external audits should begin in early 1999. Recent missions encouraged the authorities to continue functional reviews of government ministries and agencies to improve the internal regulation and control of each agency and eliminate functional duplication.
Strengthen budgetary management	The first two-year rolling government budget was submitted in October 1997. Restructuring of government units and consolidation of local governments are progressing.
Pension Reform	After reforming the first tier of the pension system in 1996, a third (voluntary) pension tier was launched in July 1998. Employee contributions are tax deductible and tax on earnings is deferred. A second pension tier, to be implemented in 2000, has been designed as a mandatory, fully-funded scheme, with benefits depending directly on contributions and returns on investment. Legislation for the second tier has been approved by the Cabinet and passed the first reading in Parliament in early 1999. The legislation is expected to be finalized and approved by early 2000, and the second tier scheme may start in 2001. Initially, the second tier is to be publicly managed and financed by 2-3.5 percentage points of the social tax.
II. Financial Sector	
Financial market development and supervision	Most of Latvia's banking prudential regulations conform to the recommendations of the Basle Committee, and the authorities have been striving to attain full compliance with the Basle Core Principles by addressing the remaining regulatory shortcomings. Last fall, in response to global financial instability, the risk-weighting of banks' non-OECD domestic currency denominated government assets was increased from zero to 50 percent and banks' exposure to non-OECD countries was limited to 25 percent of equity capital per country and 200 percent for total exposure to non-OECD countries (effective October 1, 1998). Consolidated banking supervision will be implemented from the second quarter of 1999 onwards. The introduction in 1998 of new laws on investment companies, private pension funds, and insurance companies has enhanced the regulation of non-bank financial institutions. Other new insurance laws (effective September 1, 1998) have harmonized Latvia's legislation with that of the EU. There are plans to introduce unified supervision of all (bank and non-bank) financial institutions.

Table 8. Latvia: Status of Structural Reforms

Measure	Description and Status of June 1999
Deposit insurance scheme	Deposit insurance came into effect October 1, 1998. It is primarily funded by participating banks and covers core bank deposits up to LVL500 per depositor per bank. The insurance ceiling will rise to LVL13,000 by 2008.
Anti–money laundering law	An anti-money laundering law came into force in June 1998. It defines the responsibilities of financial institutions in identifying and reporting unusual or suspicious financial transactions and establishes a Disclosures Office to monitor such transactions.
Mortgage lending	A new mortgage lending law was passed in March 1998. Loans are of one-year maturities, can be rolled over for ten years, and can amount to 60 percent of the value of the underlying real estate. By the end of 1998, real estate loans amounted to LVL25.8 million (3.5 percent of total loans), compared with LVL10.1 million (2 percent of total loans) one year earlier.
III. Trade Policy	
Tariff policy	In 1997 the unweighted average tariff for all non-agricultural goods was reduced to 4.5 percent. In January 1998, tariffs on a number of products were lowered further. In May 1998, specific import tariffs on confectionaries (except for sugar) were converted to ad valorem tariffs, and legislation has been submitted to Parliament to convert the remaining specific tariffs on alcoholic beverages and tobacco. Draft legislation to reduce the average production-weighted basic tariff on a set of agricultural products from 47 to 30 percent was approved by the Cabinet in the fall of 1998 and has passed the first of three readings in Parliament. In May 1999, Parliament passed a law increasing import tariff rates on margarine (from 1 percent basic and 0.5 percent MFN to 15 percent) and on cigarettes without filters (from zero to 25 percent basic and 10 percent MFN). However, the law also reduced tariff rates on biscuits (from 35 percent to zero) as well as several manufactured products (beauty products, soap, leather products, fur products, bed linen, footwear, headgear, umbrellas and walking sticks, feather and hair products, tools and cutlery, electrical machinery and parts, furniture, bedding, mattresses, toys and sports requisites, and miscellaneous manufactured items) from a range of 20 to 3 percent to a low range of 6 to zero percent. On May 27, 1999, Parliament passed a law increasing the tariff rate on pork imports to 70 percent despite strong objections by the government. All remaining export duties (except on books more than 50 years old and antiques) were removed on January 1, 1999.
Import licensing	Since January 1998, import licensing is virtually automatic except for weapons, explosives, and fuel. The processing period has been reduced from 30 to 10 working days and fees have been lowered to only reflect processing costs.
IV. Privatization	
Enterprise privatization	Small and medium-scale privatization in Latvia was completed by mid-1998, and only a few large-scale enterprises remain to be privatized (see Box 1 in main text for details). Sales terms for the *Latvian Shipping Company* were agreed in May and privatization is expected by the end of 1999. Privatization plans for *Latvenergo* and *Lattelekom* indicate that they will be sold in 2000.
Land privatization	As of May 1, 1999, 44 percent of all land in Latvia was in private hands. Foreign investors are restricted to less than 50 percent ownership of land, except for investors from countries with which Latvia has bilateral investment guarantees.

Table 8. Latvia: Status of Structural Reforms

Measure	Description and Status of June 1999
Apartment privatization	Apartment privatization accelerated during 1999, with 54 percent of all government-owned apartments privatized by end-April, up from 43 percent at the end of 1998.
Bank privatization	A closed share issue in March 1999 has reduced the government's share of ownership in the *Latvian Savings Bank* from 54 to 42 percent.
V. Other Reforms	
Energy sector: settlement of arrears and cost-recovery pricing	Cutoff of supplies is practiced in cases of non-payments and several cases have been brought to court. New pricing methodologies were issued in early 1998 to provide clear pricing criteria and maintain full cost-recovery pricing. In the first quarter of 1999, gas bills were being paid within 22 days (compared to the World Bank recommended average of 40 days) and electricity bills within 28 days (compared to the World Bank recommended average of 30 days).
Land registration	As of May 1, 1999, roughly 237,000 land properties were registered in the *cadastre* by owners and another 304,000 properties were registered by land users. Of the 237,000 owner-registered parcels, some 235,000 parcels were registered in the *Land Book*, the basis for registering transfers of ownership and liens against property. This is up from 179,000 parcels at end-1998.
Register for collateral	A register for collateral based on movable property was established in February 1998. By June 1999, nearly LVL900 million worth of movable properties had been registered for collateral purposes.
Business licensing regulations	On January 1, 1998 the number of entrepreneurial activities subject to licensing regulations was reduced to from 118 to 67. These activities are primarily in public health and education, finance, safety, and national security. The license requirement for international tourism was abolished in March 1999.
Judicial system	The government aims to make the work of the courts more public, develop stricter criteria for choosing judges and assessors, and prohibit judges from meeting with one party involved without the presence of the other party. Further training of judges and court personnel is needed in order for new laws, especially the new Criminal Code and Commercial Code, to be implemented effectively.
Governance	The government intends to rigorously enforce the anti-corruption law passed in 1998 and to complete the anti-corruption program initiated in 1998 in collaboration with the World Bank. In January 1999 the government signed the Criminal Law Anti-Corruption Convention prepared by the Council of Europe, which harmonizes international laws against corruption.

Source: Latvian authorities.

Table 9. Latvia: Medium-Term Macroeconomic Framework, 1996-2003 1/

	1996	1997	1998	1999	2000	2001	2002	2003
				Projection 2/				
				(In percent of GDP)				
Foreign saving 3/	4.2	5.1	9.5	8.4	7.8	6.4	5.5	5.1
Gross national saving	14.6	17.7	13.5	12.1	14.6	16.1	17.6	18.8
Public 4/	0.3	2.9	3.2	0.7	2.5	2.9	3.3	3.4
Private 5/	14.3	14.8	10.3	11.4	12.1	13.3	14.3	15.4
Gross domestic investment	18.8	22.8	23.0	20.6	22.4	22.5	23.2	23.9
Public 6/	1.8	2.5	3.9	3.9	3.3	3.3	3.3	3.3
Private	17.0	20.3	19.1	16.7	19.0	19.2	19.8	20.6
				(In percent)				
Memorandum items:								
Nominal GDP (millions of lats)	2,829	3,275	3,774	3,949	4,210	4,570	4,965	5,394
Real GDP growth rate	3.3	8.6	3.6	2.0	4.0	6.0	6.0	6.0
Inflation (year average)	17.6	8.4	4.7	2.5	2.5	2.5	2.5	2.5
Fiscal balance/GDP 4/	-1.7	0.1	-0.8	-3.5	-1.4	-1.0	-0.5	-0.4
Public debt/GDP (end-year) 7/	14.8	12.7	11.1	14.7	14.5	14.3	14.1	14.2

Sources: Latvian authorities and staff estimates and projections.

1/ Items within columns may not sum due to rounding.
2/ Projections for 1999 are based on an expected fiscal deficit of 2.5 percent (3.5 percent PAF) while projections for 2000 onwards are based on a fiscal adjustment in 2000.
3/ External current account deficit (+).
4/ Privatization receipts are classified as a deficit financing component, i.e. they are excluded from revenues.
5/ Derived as residual.
6/ Includes extra-budgetary investment in the Public Investment Program.
7/ Total public debt, comprising official foreign debt, treasury securities, and bank restructuring bonds.

Latvia: Fund Relations

(As of June 30, 1999)

I. **Membership Status:** Joined May 19, 1992; Article VIII

II. **General Resources Account**:	SDR Million	% Quota
Quota	126.80	100.0
Fund holdings of currency	166.07	131.0
Reserve position in Fund	0.01	0.0

III. **SDR Department:**	SDR Million	% Allocaton
Holdings	0.36	N.A.

IV. **Outstanding Purchases and Loans:**	SDR Million	%Quota
Stand-by arrangements	1.14	0.9
Systemic transformation	38.13	30.1

V. **Financial Arrangements:**

Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn SDR Million)
Stand-by	10/10/97	4/9/99	33.00	0.00
Stand-by	5/24/96	8/23/97	30.00	0.00
Stand-by	4/21/95	5/20/96	27.45	0.00

VI. **Projected Obligations to Fund:** (SDR million; based on existing use of resources and present holdings of SDRs):

	Overdue	**Forthcoming**				
	(5/31/99)	1999	2000	2001	2002	2003
Principal	0	4.9	7.6	7.6	7.6	7.6
Charges/interest	0	0.8	1.3	1.0	0.7	0.4
Total	0	5.7	8.9	8.6	8.3	8.0

VII. **Exchange Arrangements**:

The currency of Latvia is the lats, which was introduced in March 1993 to replace the Latvian ruble. The exchange rate has been pegged to the SDR since February 1994.

VIII **Resident Representative**:

The third resident representative of the Fund in Latvia is Mr. Demekas, who took up his post in August 1996.

IX. **Consultation Cycle**:

Latvia is on the 12-month consultation cycle. The Executive Board concluded the 1998 Article IV Consultation on March 23, 1998. At the time of the 1998 Article IV Consultation, Directors commended the authorities for their prudent financial policies and for making substantial headway toward putting in place the comprehensive structural changes required to establish a market economy. The exchange rate peg was considered to have served Latvia well and remained appropriate. Directors urged the authorities to accelerate their program of structural reform in order to foster sustained economic growth and to move toward their goal of EU accession, emphasizing in particular the importance of completing the privatization process. Other reform areas identified by Directors included strengthening property rights and the legal system more generally.

World Bank Relations

1. Latvia became a member of the World Bank on August 11, 1992. The Bank's lending programs have focused on assisting the government in deepening structural reforms and promoting private and public investment. Lending has also been designed to ensure an adequate level of public infrastructure services, improve energy conservation, and address environmental concerns. Strengthening the social safety net and the delivery of social services remain a top priority. In support of this strategy, the World Bank has 11 projects under implementation totaling US$185 million in commitments, of which US$83 million had been disbursed as of end of May 1999. In addition it has three IDF grants under implementation totaling US$0.9 million. The total amount of commitments and debt outstanding, including closed operations, is US$305 million.

2. The Bank's first loan to Latvia, the Rehabilitation Loan (October 1992, US$45 million) provided general support for early implementation of economic reform and for relieving the scarcity of critically needed imports. The Agriculture Development Project (January 1994, US$25 million) promotes private participation in agriculture by making credit available to private farmers. The Enterprise and Financial Sector Restructuring Project (September 1994, US$35 million) provides technical assistance to enhance efficiency in production as well as financial support to private sector activities. The Environment Project (December 1994, US$4 million) promotes environmentally sustainable management and aims to improve water quality and sanitation services in Liepaja. The District Heating Rehabilitation Project (May 1995, US$14 million) aims to improve the district heating system in the city of Jelgava. The Municipal Services Development Project (December 1995, US$27.3 million) builds on decentralization and intergovernmental fiscal reforms by financing investments in crucial municipal services. The Structural Adjustment Loan (December 1996, US$54 million) supports a government program to restore sustained growth through improving the policy environment for private sector development and better public sector management and use of resources. The Highway Maintenance Project (March 1997, US$20 million) supports the preservation of the road network in Latvia. The Welfare Reform Project (May 1997, US$18.1 million) supports the development of an efficient social welfare system. The Municipal Solid Waste Management Project (February 1998, US$7.95 million) supports implementation of an environmentally sustainable waste management technology. The Rural Development Project (August 1998, US$10.5 million) supports diversification of rural economy and strengthening of rural financial system. The Health Project (November 1998, US$12 million) supports the reform program in the health sector. The State Revenue Service Modernization Project (December 1998, US$5.1 million) supports strengthening the organization and management as well as the operations of the revenue administration. Projects in energy, education and solid waste management are also under preparation. The Education Improvement Project (May 1999, US$31.1 million) aims to improve education outcomes within the Latvian education sector by strengthening the management of both resource inputs and the learning process. More recently the government has inquired about the possibility to undertake a second Structural Adjustment Operation.

3. The latest World Bank Country Assistant Strategy was presented to the board in April 1998. The first World Bank report on the economy, a Country Economic Memorandum, provided a comprehensive overview of the Latvian economy. It was followed by a series of policy notes that provided advice to the government on various macroeconomic and structural reform issues. A Public Expenditure Review report provided recommendations on public expenditure planning, programming, and management. A report on local government expenditure and resource transfer analyzed aspects of expenditure and revenue priorities facing local governments in Latvia. A report on macroeconomic and financial sector vulnerability assessed the overall level of vulnerability in the economy and financial sector and proposed policies to minimize these risk factors. The Bank also has undertaken sector reviews in the areas of agriculture, public sector management, municipal finance, enterprise development, pension reform, health care, financial sector, and private participation in infrastructure. In addition, the Bank has provided technical assistance on tariff policy, customs administration, the design of a city drawback scheme, and the preparation of the public investment program.

TECHNICAL ASSISTANCE FROM THE FUND, 1994–99

DEPT	Project	Action	Timing	Counterpart
FAD	Establishment of Treasury Unit	Short-term Expert	February 1994	Ministry of Finance
LEG	Drafting of Tax Laws	Mission	April 1994	Ministry of Finance
STA	Balance of Payments	Mission	April 1994	State Committee for Statistics
LEG	Drafting of Tax Laws	Mission	May 1994	Ministry of Finance
FAD	Establishment of Treasury Unit	Short-term Expert	April/May 1994	Ministry of Finance
MAE	Supervisory Intervention, Rehabilitation and Liquidation of Banks	Workshop for BRO	May 1994	Bank of Latvia
MAE	Foreign Exchange, Banking Supervision, and Monetary Policy	Mission	July 1994	Bank of Latvia
FAD	Implementation of Treasury System	Mission	August 1994	Ministry of Finance
STA	Balance of Payments	Mission	August 1994	State Committee for Statistics
LEG	Drafting of Tax Laws	Mission	September 1994	Ministry of Finance
FAD	Tax Administration	Long-term Expert	September 1994 to November 1996	Ministry of Finance
FAD	Tax Administration	Mission	September 1994	Ministry of Finance
LEG	Drafting of Tax Laws	Mission	December 1994	Ministry of Finance
STA	Balance of payments	Mission	December 1994	Central Statistical Bureau
FAD	Tax Administration	Mission	February 1995	Ministry of Finance
MAE	Foreign Exchange, Banking Supervision, and Monetary Management	Mission	April 1995	Bank of Latvia
FAD	Tax Administration	Inspection Mission	July 1995	Ministry of Finance
STA	Multitopic	Inspection Mission	August 1995	Central Statistical Bureau
MAE	Banking Supervision	Mission	July 1995	Bank of Latvia
STA	Balance of Payments	Mission	October 1995	Central Statistical Bureau
MAE	Monetary Management	Long-term Expert	January to July 1996	Bank of Latvia
LEG	Bankruptcy Law	Mission	June 1996	Ministry of Finance
MAE	Banking Supervision	Long-term Expert	June 1996 to June 1997	Bank of Latvia
FAD	Tax Administration	Inspection Mission	September 1996	Ministry of Finance

TECHNICAL ASSISTANCE FROM THE FUND, 1994–99

DEPT	Project	Action	Timing	Counterpart
FAD	Monitoring of Treasury System	Mission	September 1996	Ministry of Finance
STA	Resident Statistical Advisor	Long-term Expert	September 1996 to December 1998	Central Statistical Bureau
STA	Inspection	Regional Expert	February 1997	Bank of Latvia/Central Statistical Bureau
FAD	Monitoring of Treasury System	Mission	June 1997	Ministry of Finance
MAE	Consolidated Banking Supervision	Mission	September 1998	Bank of Latvia
MAE	Consolidated Banking Supervision	Short-term Expert	October 1998	Bank of Latvia

Statistical Appendix

1. The authorities are fully cooperative in providing data to the Fund, mainly though not exclusively through the resident representative office. Data is transferred on a timely basis. Latvia has a well-articulated publications policy and produces a broad range of publications on economic and financial statistics on a regular and timely basis. The authorities are reporting data for the Fund's *International Financial Statistics, Government Finance Statistics Yearbook*, the *Direction of Trade Statistics,* and the *Balance of Payments Statistics Yearbook*. There is increased cooperation on data issues between the Central Statistical Bureau (CSB), the Bank of Latvia (BoL), the Ministry of Finance, and the customs authorities.

2. During the period December 1996–December 1998, a Fund Resident Statistical Advisor for the Baltic States assisted the Latvian authorities in improving the database on macroeconomic statistics. Advice on statistical matters is also provided under the EU/EFTA program of statistical technical cooperation with the statistical offices of the Baltic countries.

National accounts

3. The CSB compiles and publishes quarterly national accounts data on a regular and timely basis, largely following the *1993 SNA*. The underlying data are primarily obtained through a comprehensive set of questionnaires that the CSB sends to businesses and individuals, supplemented by information obtained from other agencies. The basic data are widely believed to understate economic activity, particularly in the private sector, and there is an ongoing effort to increase coverage. The official national accounts data published by the CSB incorporate an adjustment for under-recording, which the CSB currently estimates as 14 percent of total GDP. There are also significant discrepancies between the GDP estimates based on production and those based on expenditure and income. Different data sources, such as household expenditure and labor force surveys, employment data and tax registers are being used. Input/output tables are currently being prepared.

Prices

4. The CSB compiles a nationwide consumer price index. With Fund technical assistance, it has developed appropriate methodologies to deal with most of the technical problems resulting from the major structural shifts that have occurred in the economy. Reporting has improved markedly during 1998, in part due to the implementation of a new household budget survey, based on World Bank technical assistance, enabling the CSB to compile indices for different types of households. Following advice from EUROSTAT, the weights in the CPI basket are now revised annually. The CSB also publishes a producer price index, as well as export unit value and volume indices. An import price index based on a hybrid method with unit values and pure price data is under development.

Government finance statistics

5. The staff is provided with monthly information on revenues, expenditures, and financing of the central and local governments and special budgets. The available information permits the compilation of the consolidated accounts of the general government.

Monetary statistics

6. Monetary data are comprehensive, timely, and comply with international standards. Specifically, data on the balance sheets of the BoL, commercial banks, and other financial institutions, as well as the monetary survey, are compiled with a very short time lag, i.e., within two weeks of the end of the reporting period. The institutional coverage, classifications, and sectorization comply with Fund standards. Interest rate data are compiled and published with equally short time lags. The BoL also reports comprehensive data on banking supervision and prudential regulations.

Balance of payments statistics

7. With the help of Fund technical assistance over the recent past, significant progress has been made in the compilation of balance of payments statistics by the CSB. However, shortcomings remain in the quality of the published data, and to a lesser extent, its timeliness. Personnel constraints faced by the CSB have eased somewhat and preparations for the BOL to assume the responsibility for compiling the balance of payments statistics are proceeding smoothly.

8. Merchandise trade data are based for the most part on customs data. The implementation by the customs department of transaction-price based valuation reduces previous problems relating to the valuation of goods. With regard to trade, procedures could be strengthened to assure that goods passing through customs warehouses are properly valued and that coverage of exports to Russia and CIS countries is complete. Exports of cars and shuttle trade items are particularly difficult to capture; improved survey techniques are recommended. Estimates of travel credits and debits have been improved through a revised survey. Enterprise surveys have been instituted to collect information on other services items and the income account. Enterprise surveys, supplemented by balance sheet data from banks, are employed to estimate financial account flows. In addition, a specific foreign direct investment survey is recommended. The BOL is in the process of instituting an ITRS among the commercial banks in order to prepare monthly BOP estimates. Foreign liabilities in the international investment position data reported by the authorities are considerably larger than data reported by creditors to the BIS. The authorities, with help from the new long-term statistical advisor on the balance of payment, should make an effort to identify the sources of this large discrepancy and reconcile the data.

Data dissemination standards

9. Latvia has subscribed to the Fund's Special Data Dissemination Standard since November 1996 and has been posting metadata on the Dissemination Standards Bulletin Board since December 1997.

Survey of Reporting of Main Statistical Indicators

(As of July 9, 1999)

	Exchange Rates	International Reserves	Reserve/ Base Money	Central Bank Balance sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/ GNP	Public External Debt and Debt Scheduling
Date of latest observation	July 8	June 30	June 30	June 30	May 30	June 30	June	March	Q1	May 30	Q1 1999	May 30
Date received	July 9	May 17	May 17	May 17	May 17	July 9	July 8	May 18	July 2	June 18	June 30	June 18
Frequency of data	D	M	M	M	M	M	M	M	Q	M	Q	M
Frequency of reporting	D	M	M	M	M	M	M	M	Q	M	Q	M
Source of data	C	A 1/	A 1/	A 1/	A 1/	A 1/, C	C	A 1/, C	A 1/ C	A 1/	A, N 1/	A
Mode of reporting	E	C,E	C,E	C,E	C,E	C,E	E	C,E	C,E	C	C	V
Confidentiality	C	C	C	B	C	C	C	C	C	C	C	C
Frequency of Publication	D	M	M	M	M	M	M	M	Q	M	Q	M

Sources: A--direct reporting by Central bank, Ministry of Finance, or other official agency; C--commercial service; N--official publication or press release.

1/ Through the resident representative office.

Notes:

Frequency of data: D-daily, W-weekly, M-Monthly, Q-Quarterly.

Frequency of reporting: M-Monthly, Q-Quarterly, V-irregular in conjunction with staff visits.

Mode of reporting: C-cable or facsimile, E-electronic news reporting, V-staff visits, or O-other.

Confidentiality: (B) for use by the staff and the Executive Board, (C) for unrestricted use.

Statement by the IMF Staff Representative
July 28, 1999

1. On July 16, after the issuance of the staff report (SM/99/168, 07/12/99), a new government headed by Mr. Skele (a two-time former prime minister) was approved by the Latvian parliament. The formation of the new government followed the resignation of Prime Minister Kristopans and the collapse of the ruling coalition. The new government, in contrast to the previous one, contains the largest party and controls a large majority in parliament, suggesting that political stability may be enhanced. The composition of the new government gives reason to expect that the general policy direction of fiscal consolidation and progress on structural reform will continue. The government aims to take immediate steps to contain the fiscal deficit in 1999 and to seek further consolidation in 2000 after which a balanced budget will be maintained, to keep inflation in the 2-4 percent range, to continue to ensure the stability of the lats, and to complete privatization within one year. In particular, the new government plans to present a supplementary budget for 1999 to parliament already in the next few weeks, incorporating substantial expenditure cuts, although it is too early to tell if this goes beyond achieving the original target deficit. Furthermore, the government has expressed its clear desire to move as quickly as possible on a successor stand-by arrangement, and a mission has been scheduled for early September. The staff appraisal remains valid.

2. Macroeconomic developments continue to reflect the impact of the Russian crisis. Real GDP contracted by 2.3 percent in the first quarter on an annual basis and data on industrial production suggest that the contraction has continued in the second quarter; should final data confirm this, growth projections would need to be revisited. Consumer price inflation remained unchanged at 1.9 percent (12-month rate) in June compared with May while producer price deflation accelerated to 5.2 percent.

3. Updated balance-of-payments data suggest that the current account deficit amounted to US$87 million or about 5 percent of GDP in the first quarter, some US$50 million larger than preliminary estimates. However, large errors and omissions illustrate the continued difficulties with the balance of payments statistics and the need for further improvement in this area. End-June gross official reserves stood at US$1,007 million or 3 months of imports, some US$30 million less than projected reflecting in part a reevaluation of the price of gold.

4. As to fiscal developments, tax revenues improved marginally in the second quarter; nominal revenues from consumption taxes were 3.9 percent lower than a year earlier, compared with a 9.8 percent decline in the first quarter. On the expenditure side, the category transfers to households (unemployment benefits and pensions) recorded the highest increase compared with the previous year. The government continued to restrain discretionary spending, especially investment and net lending, both of which remained well below budget. As a result, despite the disappointing revenue performance, the authorities

were able to limit the consolidated central and local government deficit to about LVL69 million excluding privatization receipts or 3.7 percent of projected six-month GDP.

5. Monetary developments continue to show signs of a return to stability and most monetary aggregates, with the exception of net foreign assets of commercial banks, are now back at their pre-crisis levels. Reserve money and broad money grew by 3.2 percent and 4.6 percent, respectively, in June while nongovernment credit rose by 0.9 percent. The average risk-weighted capital adequacy ratio for the banking system stood at 16 percent at end-June, down from 18 percent at end-March. The rehabilitation plan for the Rigas KomercBanka remains under consideration and medium-sized depositors are now being asked to convert their deposits into capital. If the required capital cannot be obtained by mid-August, legal proceedings for liquidating the bank will be initiated.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 99/71
FOR IMMEDIATE RELEASE
August 10, 1999

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes Article IV Consultation with Latvia

On July 28, 1999, the Executive Board concluded the Article IV consultation with Latvia.[1]

Background

Latvia has a solid record of macroeconomic stability and substantial progress on structural reforms. At present, the authorities are facing the challenge of maintaining a balance of economic policies aimed at limiting the impact of the Russian crisis while ensuring a sustainable external position. Significant steps forward have also been made toward concluding the agenda of structural reforms, which will ensure future sustainable growth.

Macroeconomic developments were severely affected by the Russian economic crisis. Real GDP declined by 1.9 percent in the fourth quarter of 1998 and further contraction is estimated for the first quarter of 1999. As a consequence, the rate of unemployment rose to 10.1 percent in May, up from 7 percent a year earlier. Meanwhile, inflation has continued to fall amid continued tight monetary policy and weak domestic demand, reaching 1.9 percent in May. The current account deficit surged to 9.5 percent of GDP in 1998 but has since narrowed substantially reflecting the slowdown in economic activity and continued robust export growth to non-CIS countries. Capital inflows remained strong in 1998 as increased medium and long-term borrowing by banks and

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. In this PIN, the main features of the Board's discussion are described.

enterprises offset a decline in foreign direct investment; external public debt remained at 7.4 percent of GDP.

The consolidated general government ended 1998 with a slight surplus, contributing to lower inflation and interest rates and providing room for a marked expansion of private sector credit. The 1999 fiscal budget aims for a consolidated fiscal deficit of 2.8 percent of GDP, based on an 8 percent growth in revenues and a 13 percent growth in expenditures. As a result of the economic slowdown, overall tax revenues only increased by 1.5 percent on an annual basis during the first four months of 1999. With several expenditure items restrained at their 1998 levels ahead of the February budget approval, the fiscal deficit was contained at 0.9 percent of GDP in the first quarter. However, with the Budget Law coming into effect, expenditures have started to increase sharply.

Monetary developments in the second half of 1998 were to a large extent dominated by the August events in Russia. Reserve money, broad money and net foreign assets of the BoL and commercial banks declined in the months immediately following the outbreak of the crisis. The situation has since stabilized and over the year, reserve and broad monies grew by 7 percent and 6 percent, respectively. However, most monetary aggregates still remain below their pre-crisis levels and in March there was a temporary bout of uncertainty as the largest commercial banks experienced significant withdrawals of deposits amid reactions to the suspension of operations of Rigas KomercBanka and in anticipation of the publication of banks' audited 1998 financial statements. Longer-term lending rates and interbank rates rose substantially following the outbreak of the crisis but have since stabilized and even started to decline. Nongovernment credit growth has slowed substantially since August, rising by 51 percent in 1998 and by 3.3 percent in the first quarter of 1999. There are currently no signs of a deterioration in bank loan portfolios as a result of the very high credit growth in the first half of 1998 and non-performing loans have declined since 1997.

As a result of the Russian crisis and the ensuing deterioration in banks' domestic operating environment, most prudential indicators, including earnings and liquidity, worsened in 1998. The average risk-weighted capital adequacy ratio declined from 21 percent at end-1997 to about 17 percent at end-1998. The process of banking sector consolidation has continued: as a result of bank closures, suspension of operations, and mergers, the number of operating banks recently declined to 24 compared with 30 at end-August 1998. Still, despite its current difficulties, the banking sector has been successful in attracting significant FDI flows, particularly from Scandinavia. In response to the financial spillover from Russia, prudential regulations were further tightened through increased risk weight for non-OECD sovereign debt instruments and the introduction of limits on country exposure. The authorities have also continued to strengthen general banking supervision, moving Latvia close to full compliance with the Basel Core Principles and relevant EU directives. Development of non-bank financial intermediaries has been supported by improvements in the legal framework, and a law on the creation of a unified financial sector supervisory agency is currently being drafted.

Latvia continued to make progress in trade liberalization in 1998 and 1999, and in February this year, Latvia formally joined the WTO. Most specific import tariffs have been converted to ad valorem tariffs and basically all export duties have been removed. In 1998, a new system of customs valuation was implemented. There have been several tariff reductions thus far in 1999 and only a few increases, including a recent temporary increase in the import tariff on pork meat to 70 percent in response to dumping allegations. The average production-weighted MFN tariff for agricultural products has been reduced to 34 percent but a proposal under the previous SBA to further reduce agricultural tariffs has not yet been passed.

Executive Board Assessment

Executive Directors commended the authorities for the continuation of prudent financial policies in 1998 and for the progress with the comprehensive structural changes required to establish a market economy. They noted that overall growth performance had been satisfactory in 1998, despite the adverse impact of the Russian crisis, and inflation had declined more quickly than expected. Looking forward, Directors stressed the need to pursue sound fiscal and monetary policies to support the exchange rate peg, to rapidly conclude the agenda for structural reform, and to further strengthen the financial system.

Noting Latvia's record of prudent fiscal policy in underpinning its positive economic performance, Directors were concerned by the significant expansion of the fiscal deficit foreseen under the 1999 Budget Law, and emphasized the need to ensure underlying fiscal stability. They welcomed the new government's reassessment of the economic situation and its plans for immediate steps to achieve fiscal consolidation in 1999, and for further measures in 2000. Directors also welcomed the new authorities' intention to formulate an economic program that could be supported by the Fund. Building on their efforts so far, the authorities were encouraged to continue to broaden the tax base and improve tax collection. Overall, however, Directors considered that the primary emphasis in fiscal consolidation should be on containing expenditure pressures. In this regard, they referred in particular to the need to reform the pension system and also the civil service while ensuring appropriate restraint in public sector wages.

Directors considered that the exchange rate peg to the SDR had served Latvia well and remained appropriate, even though a switch to a euro peg in the medium term appeared to be desirable. Directors agreed that Latvia's external position was broadly sustainable, given the strong productivity growth in the past several years, which had contributed to a sharp increase in the share of exports to the EU, as well as the substantial inflow of foreign direct investment. However, in light of the doubling of the current account deficit in 1998, Directors emphasized the essential need to continue to monitor the external position carefully, particularly in view of the still volatile international situation. They welcomed the authorities' readiness to further tighten fiscal policies in the event of adverse balance of payments developments and also noted the critical role of credit policy in sustaining the pegged exchange rate.

Directors were encouraged by the increased confidence in the financial system and the steps taken by the authorities to strengthen the supervisory framework of banks and nonbank financial institutions over the past several years. They noted that the Russian financial crisis had revealed important weaknesses in the Latvian banking system, but commended the authorities for their quick reaction to the situation by further tightening prudential regulations and immediately extending liquidity support to the banking system. They considered that the share that the Bank of Latvia would assume in the Riga Komercbank (RKB) should be divested as soon as market conditions allowed. Directors urged the authorities to be vigilant for any signs of deterioration in the quality of loan portfolios, to continue raising prudential standards, and to facilitate wherever possible further orderly consolidation of the banking sector.

Directors recognized that structural reforms had reached an advanced stage. However, they stressed that a determined effort was needed to reinvigorate the process in certain areas. They expressed concern regarding the slowdown in large-scale enterprise privatization, while also noting the need for privatization to be carried out in a manner that would contribute to the ultimate goal of promoting efficiency. Directors also expressed some concern about the incomplete program of reduction in agricultural tariffs and occasional initiatives to reverse trade liberalization.

Directors welcomed progress made in apartment privatization, land registration, the strengthening of property rights, and continued improvements in the business climate and in governance, even though they considered that further efforts were still needed in all these areas. They encouraged the authorities to continue to strengthen their legal system, in particular through greater consistency in the implementation of laws and regulations. They also encouraged efforts to further reduce barriers to foreign investment and to address the need for modernization in agriculture.

Directors welcomed Latvia's participation in the pilot project for the publication of Article IV staff reports.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Latvia: Selected Economic Indicators

	1995	1996	1997	1998 1/
Real Economy		*In percent*		
Real GDP, annual change	-0.8	3.3	8.6	3.6
CPI inflation, period average	25.1	17.6	8.4	4.7
Unemployment rate	6.6	7.2	7.0	9.2
Domestic saving, in percent of GDP	14.0	14.6	17.7	13.5
Domestic investment, in percent of GDP	17.6	18.8	22.8	23.0
Public Finance		*In percent of GDP*		
General government balance	-3.9	-1.7	0.1	-0.8
General government debt	14.8	12.7	11.1	14.7
Money and Credit		*Changes in percent*		
Reserve money	2	25	30	7
Broad money	3	20	39	6
Domestic credit to nongovernment	-45	1	76	51
One-month treasury-bill rate, in percent, per annum	30.1	10.1	3.5	6.3
Balance of Payments		*In percent of GDP*		
Trade balance	-13.0	-15.5	-15.0	-17.7
Current account	-0.4	-4.2	-5.1	-9.5
Gross international reserves (in months of imports)	3.2	3.1	3.0	2.7
Foreign direct investment, stock	11.8	17.7	25.3	27.9
Exchange Rate				
Exchange rate regime	Peg to the SDR; 0.79 LVL per SDR			
Exchange rate, lats per US$, end period	0.537	0.556	0.59	0.569

Sources: Latvian authorities; and IMF staff estimates.

1/ Preliminary.

Statement by Kai Aaen Hansen, Executive Director
for the Republic of Latvia
July 28, 1999

Introduction

Staff has provided a fair and balanced description of the relatively eventful year for the Latvian economy since the previous Article IV discussion. As a small and open economy, Latvia will always be subject to external influences, and the recent impact from the Russian economic crisis is yet another evidence of this. The time since our last meeting in November has also been somewhat turbulent on the political scene, and a new coalition government came into power earlier this month. The new government is in broad agreement with staff's assessment and policy recommendations, and it is their intention to immediately take firm measures in several key areas to stabilize the economic situation.

Early accession to the European Union remains Latvia's overall strategic objective, and the desire to integrate into the economic structures of the EU has created a consensus for acceleration of reforms in Latvia. My Latvian authorities have also made great progress in improving the consistency of economic policy making through the adoption of a medium-term strategy and Joint Assessment of Economic Policy Priorities with the European Commission in early 1999.

Fiscal Policy

Fiscal policy has taken center stage in Latvia, largely because the fixed exchange rate regime gives limited scope to active use of monetary policy. Thus, fiscal policy remains a key compcnent in a strategy aimed at establishing the foundation for sustainable economic development. Indeed, Latvia has a tradition of very prudent fiscal policy, which has contributed to macroeconomic stability and low inflation.

Over recent years the authorities' commitment to sound fiscal policies have considerably improved the climate for economic decision making and investment, and provided scope for a market expansion of credit to the private sector. The actual outcome of the government budget balance in the previous two years was more favorable than projected, notwithstanding the pressures of the 1998 parliamentary elections and the consequences of the Russian crisis.

Due to economic slowdown in 1999, fiscal policy remains at the core of attention of the government. A more expansionary stance for this year's budget was, up until recently, considered appropriate in light of the economic downturn. The new government, however, is somewhat more in line with staff's view on what is the appropriate level of the budget deficit. The political consensus has been achieved with a view to avoiding expansionary fiscal policy in light of the more uncertain external environment. Hence, the government has already declared its intention to present a supplementary budget that would come into effect in

September and aim at reducing the fiscal deficit this year to around 3 percent of GDP. For the next fiscal year, the government intends to bring the budget even closer to balance. This is expected to alleviate, to some degree, the external imbalances.

The government has also begun to design fiscal policies in a medium term framework geared towards maintaining sound macroeconomic fundamentals, and with a view to achieving gradual convergence to EU standards, and attracting the financing of EU Structural Funds.

Monetary and Exchange Rate Policy

The peg to the SDR has served Latvia well, and the advantages of a fixed exchange rate arrangement have been widely recognized. At the same time, the possible constraints on economic development and competitiveness have been very limited as reflected in the fact that Latvia, in many respects, is one of the more successful transition countries, and in the fact that the appreciation of the real effective exchange rate has led to only marginal losses of competitiveness vis-a-vis Latvia's main trading partners. In addition, the peg to the SDR has minimized the fluctuations that would otherwise have been more pronounced in case of a peg to a single currency. Although the authorities are technically prepared to switch the peg to the euro at any time, and the Bank of Latvia (BOL) is fully authorized to do so, they feel obliged to thoroughly consider all implicit and explicit consequences of revising the exchange arrangement. They will carefully study all possible changes in the behavior of various foreign trade agents and, equally important, closely follow the performance of the euro in world financial markets.

During the first five months of 1999, nearly 64 percent of Latvia's foreign trade was with the European Union. However, more than one third of total exports is with three countries staying outside the EMU - the United Kingdom, Sweden and Denmark. Thus, Latvia is somewhat less dependent on the behavior of the euro, compared to some other transition countries whose European trade is more directed at the single currency area.

Furthermore, it is important to ascertain that the currency composition of Latvia's foreign trade by and large corresponds to the composition of the SDR basket. Currently, roughly forty-seven percent of the foreign trade transactions are carried out in US dollars, indicating that the link to the SDR still is relevant. It would be reasonable, however, to expect that a gradual shift to a wider use of the euro would somewhat reduce the importance of the dollar in Latvia's foreign trade in the future. If and when that happens, pegging the national currency to the euro would be a logical step, perfectly in tune with Latvia's pre-accession strategy.

Privatization and other Structural Reforms

While my authorities have been making good progress regarding structural reforms, they are conscious of the need for a deepening and broadening of reforms in various areas in order to reach Latvia's full growth potential. Staff rightly notes that there has been some delays in the privatization of large enterprises compared to the original schedule. This is a difficult and in certain ways sensitive process that needs careful considerations.

The new government has declared that it will attach high priority to accelerating the privatization process, but, at the same time, it will be careful in choosing the most efficient ownership structure and not risk ending up with inefficient private monopolies. They envisage privatization of the Latvian Shipping Company to be in place before the end of the year, and the remaining state owned enterprises within a year's time. In addition to improving competition and corporate governance, a successful completion of the privatization process will be beneficial in attracting foreign direct investment, thereby contributing to a strengthening of the foreign balance.

Financial Sector Issues

The Russian crisis has indeed had a significant impact on the Latvian banking system. To varying degrees several banks were relatively highly exposed to ruble denominated assets. Hence, a number of banks ended up making losses in 1998, and three small banks have been closed or suspended. In this way, the shock contributed to speeding up the consolidation of the banking sector, and the number of banks have now come down to 28, compared to 65 in 1994. The fifth largest bank, Rigas KomercBanka (RKB), became insolvent and its operations were suspended. Intensive negotiations on a recapitalization plan are still ongoing, and while a large number of private depositors have indicated their willingness to capitalize their deposits, the new government has yet to confirm its participation in providing funding. As regards the involvement of Bank of Latvia in this process, the Bank did consider at an early stage of the Russian crisis that the failure of RKB could have significant systemic repercussions. Therefore, BOL decided to provide the bank with collateralized liquidity support in an attempt to revive the bank. They are in full agreement with staff that their share holdings in the bank should be divested as soon as possible, and they are firmly committed to doing so.

As well illustrated in the Selected Issues paper, my Latvian authorities have not spared any efforts, or time, during the past year to improve bank supervision and prudential regulations. The cooperation with and assistance from highly qualified Fund experts in this area has been excellent and the authorities are highly appreciative of these efforts. The aim in this area is to align BOL's regulatory framework fully with the Basel Core Principles of Effective Bank Supervision and the relevant EU directives. Limiting banks' exposure to individual non-OECD countries and groups of countries as well as raising the risk weights on non-OECD government debt for calculating the capital adequacy ratio are examples of regulatory measures that have been implemented in the wake of the Russian crisis.

External Balance

The current account deficits widened in 1998 to 9.5 percent of GDP. However, with still robust export to non-CIS countries, total exports in 1998 grew by 11 percent. As imports declined in the wake of the slowdown of domestic demand, the current account balance improved somewhat in the first quarter of this year. My Latvian authorities recognize the importance of the reduction of the current account deficit by further fiscal tightening. However, the concerns about the magnitude and medium-term sustainability of the current account should not be exaggerated. First, there is no evidence of over-valuation of the national currency. Second, a significant share of the growth of imports is the counterpart of the large FDIs and other private long-term capital inflows. The ongoing restructuring of enterprises as well as economic reorientation are considered to be the principal factors in coping with the problem of the current account deficit in the medium term.